Cross-Border Distribution of Funds – The Devil is in the Detail

15 March 2019

It has been a year since the European Commission published its much criticised proposals for a new cross-border distribution regime for investment funds[1]. After back and forth between the Council and the Parliament's ECON Committee, the eagerly awaited (but still provisional) compromise texts[2] are now available—and, although many aspects are more positive than they might have been, they are a mixed bag.

Background. The Directive on Alternative Investment Fund Managers ("AIFMD")[3] aimed to create a uniform management and marketing regime for investment funds in the EU's single market. However, while marketing is subject to unified rules, the understanding of what "marketing" means varies greatly between different EU Member States. In some countries, "marketing" can mean any form of advertising (with the consequence that it can only be conducted after having obtained marketing approval), while in others, nothing less than the provision of near-final fund documents would count as "marketing" (and, therefore, a lot can be done prior to having obtained marketing approval). Member States coined the term "pre-marketing" for any distribution activity that did not meet the "marketing" threshold in their respective jurisdiction, and pre-marketing now means something different in each Member State.

Partly in response to market criticism of this fragmented approach, the European Commission proposed a new Directive (the "Draft Directive"), amending the AIFMD (and the UCITS[4] Directive), as well as a Regulation amending the EuVECA[5] and EuSEF[6] Regulations, to harmonise the rules. Both texts are now going through the process of

1 Legislative proposals on facilitating cross-border distribution of investment funds.

2 Proposal for a Regulation COM(2018)0110- C8-0110/2018-2018/0045(COD) and Proposal for a Directive - COM(2018)0092 - C8-0111/2018 - 2018/0041(COD).

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

4 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).

5 Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds.

6 Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds.

the legal-linguistic review and the European Parliament is expected to vote on its first-reading positions in mid-April.

Key aspects of pre-marketing. "Pre-marketing" (that is, distribution-related activities, which can be conducted without having obtained marketing approval) is now defined in the Draft Directive. Pre-marketing occurs when an authorised EU fund manager provides certain information to potential EU investors in order to test their interest in an EU investment fund ("AIF"). The EU AIF may or may not have been established at this point, but it will not yet have obtained the relevant marketing passport or, in the AIFM's home Member State, regulatory approval to market the relevant AIF.

The information that may be provided in the course of permitted pre-marketing must not:

- enable investors to acquire units or shares of an AIF;
- amount to subscription forms or similar documents (whether in draft or a final form); or
- amount to final constitutional documents or final offering documents of an AIF that is not yet "established".

If draft offering documents are provided, they must not contain "sufficient information" to allow investors to take an investment decision. Unfortunately, it is not clear what that requirement means in practice, and the risk is that regulators may take different views. We would hope that regulators will take the view that, as long as the information is not yet final and is subject to further negotiation, it will not be "sufficient".

Pre-marketing documentation. Currently, EU AIFMs are not required to notify any regulator prior to engaging in pre-marketing activities. This is set to change: under the new rules, AIFMs will be required to document pre-marketing efforts and to notify their competent home state regulator no later than two weeks after pre-marketing has started. The competent home state regulator will then inform the competent host regulator in those Member States where pre-marketing is being performed. This will add an additional regulatory complication to the marketing process.

EU AIFMs will be explicitly obliged to ensure that, after pre-marketing by the AIFM, investors who have been approached during pre-marketing do not subscribe to the AIF unless and until the relevant marketing passport (or, in the case of investors in the AIFM's home Member State, regulatory approval to market the relevant AIF) has been obtained. It is not absolutely clear from the wording whether any subscription to an AIF by any investor that takes place within 18 months of pre-marketing activity will necessarily be considered to have subscribed as a result of (pre-)marketing, or whether there is still room for reverse solicitation where an investor subscribed on its own initiative and was not contacted in the course of pre-marketing activities. In our view, it should still be possible to rely on reverse solicitation where it can be shown that an investor requested to subscribe to a fund on its own initiative, independently from any pre-marketing activity. Hopefully, regulators will share that view.

Placement agents. A further important, and unfortunate, proposed change would restrict pre-marketing undertaken on behalf of an AIFM to MiFID investment firms, EU credit institutions and other regulated fund managers. This seems unnecessary, given that pre-marketing does not usually entail investment advice in the form of a personalised recommendation or client order handling, and does not typically fall into the scope of activities regulated under MiFID. There seems to be no need to exclude placement agents operating outside the scope of MiFID, such as, for example, nationally regulated intermediaries, especially since pre-marketing will necessarily be followed by a regulated marketing procedure.

De-notification. Currently, it is possible to de-notify funds in certain jurisdictions once marketing has ended, but the rules vary from country to country. The Draft Directive proposes a harmonised de-notification regime, which, for open-ended funds, requires a mandatory redemption offer to investors from the relevant Member State. Any de-notification is then followed by a 36-month blackout period, during which the AIFM may not engage in pre-marketing of any AIFs referred to in the notification, or of any AIFs with similar investment strategies or investment ideas.

Presumably, the extension of the blackout period to AIFs with similar investment strategies or investment ideas is intended to address concerns about circumvention. However, this provision could be problematic for some firms. Many sponsors offer a broad range of different (but similar) products, with the same overall strategy but with variations in geographic focus or target market segment, or the same investment strategy but adapted to specific needs of certain investor groups. A broad interpretation of the blackout period may inhibit AIFMs from de-notifying unnecessary marketing passports, unless they are prepared to avoid marketing certain other products in the relevant country for three years. However, for EU managers, this concern may be somewhat theoretical. In practice, de-notification is mainly relevant to non-EU managers who market their products through national placement regimes ("NPPRs"). They often de-notify in order to avoid having to fulfil on-going obligations. As we shall discuss below, it is not clear whether this change will also ultimately apply to such non-EU managers.

Third-country managers. On the face of it, the new distribution rules only affect EU AIFs managed by EU AIFMs. In line with the overall approach of the AIFMD, unless and until the third-country passport is activated, inbound third-country managers and funds are subject to the national laws of the individual EU Member States. However, the recitals in the Draft Directive state that national laws on marketing by third-country managers should not disadvantage EU AIFMs. That suggests that national regulators may adopt the same approach for third-country managers as for their EU-based counterparts.

It remains to be seen whether national regulators will take a reasonable and proportionate approach to transposing the new marketing regime into their NPPRs for third-country funds. Pre-marketing is vital for such managers: they need to assess investor interest before making NPPR filings in each Member State where there may be interest. An overly restrictive interpretation of the information the manager is able to provide during pre-marketing will restrict the efficacy of this approach.

Secondly, the 18-month rule could cause some issues for a third-country manager if it is interpreted in an unhelpful way. If that rule were interpreted to mean that any investor in a jurisdiction in which pre-marketing has taken place—whether that investor was contacted during pre-marketing or not—had been subjected to "marketing" that would be problematic. It would be an unfortunate result if managers who had been sought out, on a genuine reverse solicitation basis, by sophisticated and perennial investors could not admit these investors without an NPPR registration only because the manager had also engaged in fruitless pre-marketing in the relevant jurisdiction to test the waters with other potential investors.

Thirdly, it would be problematic if national regulators decided to extend the 36-month de-notification blackout period to their NPPRs. Marketing of closed-ended funds comes to an end early in the fund's life, and it is therefore common practice for such funds to cancel marketing filings in countries from which no investor was ultimately admitted to the fund. That avoids the manager being subject to regulatory obligations (including annual reporting requirements) in Member States with which the fund has no ties—presumably something that the regulators (who have to process the filings) would not want. However, since the proposed blackout period also covers funds with "similar investment strategies" or "ideas", de-notification by some multi-fund managers could be inhibited. That problem will be exacerbated if third-country managers have to file a marketing notification before being able to assess interest in the fund.

Next Steps. The European Parliament is expected to vote on this proposal during the 15-18 April plenary session, with the Council of Ministers adopting the texts thereafter. The Directive and the Regulation will enter into force 20 days after being published in the Official Journal and will apply, or will have to be implemented in national law, two years later.

Comment. An alignment of applicable marketing rules is generally welcome. However, there are several points that give cause for concern. Many provisions remain somewhat ambiguous and the intended result of further harmonisation, smoother and easier marketing for fund managers, will be subject to legislators and regulators taking a reasonable approach. Only after transposition in national law, and once we have an idea of regulators' interpretation and practices, will it be possible to judge whether the Draft Directive represents a positive or a negative development for the industry.

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