

Client Update

MiFID II Reshapes Fundraising to European Clients: What Investment Firms and Fund Sponsors Need to Know

On January 3, 2018, the revised Markets in Financial Instruments Directive and corresponding regulation (“MiFID II”) will take effect across the European Union. The new regime will add complexity to the launch and marketing of investment funds and other financial products to investors in Europe¹. However, it will also make it easier for non-EU financial intermediaries to provide regulated services to clients in Europe. With less than six months to go, market participants should prepare for the implementation of the new rules and be ready to take advantage of the new market opportunities they could potentially present.

NEW PRODUCT GOVERNANCE RULES: FUND STRATEGIES AND PERFORMANCE NEED TO BE SUITABLE FOR THE TARGET INVESTOR BASE

MiFID II introduces new rules designed to ensure that financial products sponsored by EU investment firms and recommended and marketed to investors in Europe are tailored to the targeted investor base. These rules will apply to the entire product cycle of a financial instrument, from initial structuring to distribution and regular monitoring. Investment firms will be required to carefully review and modify their new product development and launch processes to ensure that they are compliant with these rules.

MIFID II DOES NOT APPLY TO ALTERNATIVE INVESTMENT FUND MANAGERS BUT WILL AFFECT THEM INDIRECTLY

The new rules apply to EU-based “investment firms”. Investment firms include investment advisers, banks, portfolio managers and other financial intermediaries that provide regulated financial services to all types of investors irrespective of their knowhow and sophistication

¹ This includes all member states of the European Economic Area (“EEA”). The EEA comprises the 28 member states of the European Union (including, for the moment, the United Kingdom), together with Norway, Iceland and Liechtenstein. It does not include Switzerland.

including retail investors, professional investors and eligible counterparties². Alternative investment fund managers (“AIFMs”) are generally not subject to the MiFID II rules.³ However, AIFMs should nevertheless become familiar with the national rules of the member states in which they are active. The UK Financial Conduct Authority (“FCA”), for example, issued a policy statement this month (PS 17/14), which provides that certain MiFID II requirements (including product governance rules and the requirement for recording phone conversations and electronic communication (taping)⁴) will apply as guidance to UK AIFMs subject to regulation in the United Kingdom. French AIFMs will also be subject to certain product governance rules, at least when marketing their funds in France.

Additionally, EU investment firms (such as placement agents and EU-based investment advisers) are likely to require detailed information from fund managers for which they provide marketing services. This includes information on the EU target investor base and expected performance and risk profile in order to comply with their own MiFID II obligations.

Finally, the European Securities and Markets Authority (“ESMA”) has already indicated that some of these requirements may also be incorporated in the Alternative Investment Fund Managers Directive (“AIFMD”). This would certainly be consistent with the AIFMD’s approach to protect even professional investors by imposing additional requirements and regulations on fund managers. If these requirements are adopted for AIFMs, EU AIFMs would be subject to the same rules as investment firms. The extent to which non-EU AIFMs would be subject to these rules remains uncertain for now. It seems likely that member states’ national private placement rules would require compliance whenever such investments are marketed to investors in Europe.

Even if the AIFMD is not amended, the new MiFID II rules will apply as a practical matter to AIFMs employing placement agents when marketing to investors in Europe. The placement agents will be subject to the new MiFID II rules and will have no alternative but to contractually require AIFMs to adhere to the rules and provide the required information.

² Eligible counterparties are professional clients who are active in the financial sector and who are deemed to have the experience to take investment decisions on the basis of their corporate profile. It only applies in respect of certain investment services and can be considered to be a sub-category of professional clients.

³ EU AIFMs may be subject to MiFID II requirements to the extent they provide certain financial services covered by their authorization other than managing funds (e.g., providing investment advice).

⁴ Regarding the newly introduced MiFID II requirement, see also below under the heading “Recording of Telephone Calls and Emails”. With respect to the taping rules already in place in the UK, the FCA, however, removed the current qualified exemptions for fund managers and thus extended the scope also onto fund managers.

TARGET INVESTOR BASE, EXPECTED PERFORMANCE AND MARKETING STRATEGY – CONSISTENCY IS PARAMOUNT

EU-based investment firms will need to establish a product approval process that provides for internal review and sign-off with respect to each financial instrument being launched, recommended or marketed to EU investors. The purpose of such approval process is to ensure that expected performance, risk profile and marketing strategy are appropriate for the defined investor target group.

According to ESMA,⁵ a target market is identified by evaluating the prospective clients for whom the product is intended. The evaluation relates to the knowledge and experience of those clients, their financial situation and ability to sustain losses, their risk tolerance, and their investment objectives and needs, as well as the risk/reward profile of the products. The definition of the target market requires a significantly broader assessment of the potential client base than a simple determination as to whether a prospective client is a professional or retail investor.

The expected return and the risk profile must be consistent with what the prospective client might reasonably expect in light of the client's investment objective. The marketing strategy should take into account the target market thus defined to ensure that marketing efforts are adapted accordingly.

REGULAR MONITORING THROUGHOUT THE MARKETING PROCESS

Investment firms are required to review the identification of the target market periodically throughout the marketing process to ensure that the products continue to be marketed consistent with the needs, characteristics and objectives of the identified target investor base.

RECORDING OF TELEPHONE CALLS AND EMAILS

MiFID II also introduces, for the first time, an EU-wide harmonized requirement on investment firms and banks to record telephone conversations and electronic communications relating to (or intended to relate to) transactions concluded, for example, when providing client order services that relate to the reception, transmission and execution of orders with respect to all types of clients.

THE GOOD NEWS: NON-EU INVESTMENT FIRMS GET ACCESS TO EU MARKETS

MiFID II introduces a “passport regime” for non-EU investment advisers, portfolio managers (other than AIFMs) and other regulated financial intermediaries. The regime will give them access to EU clients on a cross-border basis. With this new MiFID passport, non-EU firms will

⁵ ESMA, Final Report on Guidelines on MiFID II product governance requirements, 2 June 2017, ESMA35-43-620.

be able to provide regulated services, including investment advice and portfolio management services, to clients in Europe if (among other things) their home jurisdiction meets certain equivalence standards. Until now, these services could only be provided by establishing a subsidiary in the relevant member state and applying for an authorization in that EU member state.⁶ Only a few EU member states currently provide for limited exemptions in their national laws that allow non-EU investment firms to provide certain services on a cross-border basis from outside Europe without the need for an authorization from that member state.⁷ It remains to be seen whether these exemptions will remain in place. Most of these countries are more likely to repeal the exemptions once the passport regime has been implemented.⁸

Similarly, the passport regime will allow non-EU investment firms to provide regulated services⁹ in Europe on a cross-border basis or by opening a branch in Europe:

(1) The **cross-border model** will allow a firm to conduct its business from its home country on a cross-border basis in Europe. This option is available only if the non-EU investment firm is targeting per se professional investors and eligible counterparties. The non-EU investment firm must register with ESMA, which will require that:

- a positive equivalence decision has been adopted by the European Commission with respect to the investment firm's home country;
- the investment firm is duly authorized and subject to effective supervision and enforcement in its home country; and
- a cooperation agreement has been executed between ESMA and the regulator in the home country of the investment firm.

After registration with ESMA, the passport will allow the non-EU investment firm to provide its regulated services in all EU member states.

(2) The **branch model** is subject to the requirements described above and will only be available in member states that allow this model. If permitted, the branch model will allow a non-EU investment firm to conduct its regulated business with retail and

⁶ This is the case, for example, in France.

⁷ Germany and the UK permit some services to be provided on this basis, subject to certain requirements and limitations.

⁸ In Germany, the national exemption remains in place, but its future relationship to the passport regime remains unclear.

⁹ The MiFID II rules will not amend the marketing rules under the AIFMD for fund managers that market their funds directly in Europe.

elective professional clients¹⁰ through an EU branch. It will have to meet the minimum conditions for authorization in addition to the ones described above. These conditions will be established by the member state in which the branch is established.

Like the cross-border model, the branch model affords passport rights in other EU member states only with respect to professional investors and eligible counterparties. This means that a non-EU investment firm may need to establish a branch in each member state in which it wishes to conduct business with retail and elective professional clients. If a member state elects not to implement the branch model, it may continue to operate its existing national regime, which may or may not grant access to the relevant market. The national regimes, however, may not treat non-EU investment firms more favorably than EU firms.

Not all member states will elect the branch model. For example, France will allow the branch model. Germany, on the other hand, will continue to treat a branch of a non-EU investment firm as a separate investment firm, which will be subject to a license requirement under German law. The German regulator may, however, grant an exemption from the license and other regulatory requirements on a case-by-case basis.

Brexit has put a spotlight on the issue of third-country access. Once Britain has left the European Union it will be a third country. The only way to provide investment services to clients in Europe will be by being able to use the third country passport regime. Because the United Kingdom currently remains an EU member state and has fully implemented EU law, it would be difficult to deny UK “equivalence”, at least as long as the UK keeps such EU law in place following Brexit. It seems unlikely that the UK government would make significant alterations to its regulatory regime. However, the process and timing of recognizing UK equivalence may be politically charged.

CROSS-BORDER SERVICES CAN BE PROVIDED WITHOUT A LICENCE ON A REVERSE SOLICITATION BASIS

Finally, MiFID II explicitly clarifies that services may be provided on a reverse solicitation basis, without requiring authorization or registration in Europe. Reverse solicitation is currently permitted under the AIFMD if an investor approaches the AIF or AIFM on its own initiative. Under the German interpretation of the AIFMD, the concept of reverse solicitation is only available with respect to professional and German semi-professional investors. MiFID II explicitly provides that reverse solicitation will be available for retail clients as well, although we expect that the rules in this context are likely to be interpreted restrictively.

¹⁰ Certain clients that are not professional clients per se but may opt to be treated as professional clients.

LOOKING FORWARD, WHAT FIRMS NEED TO DO

- **EU investment firms** that sponsor and launch fund products will be fully subject to the rules and should set up product governance rules.
- Although not subject to MiFID II, **EU fund managers** may be subject to some of the MiFID II requirements imposed or recommended by their national regulators. In any event, both **EU and non-EU fund managers** should expect to become indirectly subject to the rules on a contractual basis by their EU placement agents or investment advisors.
- Going forward, it is likely that the MiFID II rules will be integrated into the AIFMD and in the national private placement regimes applicable to non-EU fund managers marketing in Europe.

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Please do not hesitate to contact us with any questions on the new rules or for assistance with their implementation.

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