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# A Sign of Things to Come? European Regulatory Development Affecting Structured Products

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# Overview

- European Regulation
  - Proposals relating to PRIPs
  - Potential impact of MiFID II
  - Product intervention initiatives
  - Changes to the Prospectus Directive and their impact on structured products
  - UCITS and ETF developments
  - UK retail distribution of unregulated collective investment schemes

# PRIPS

# Background

- Initiative dates back to ECOFIN request to EU Commission in 2007 and subsequent Call for Evidence
- Aim to seek greater consistency and more level playing field in regulation across different investment products
- Increased focus on investor protection following financial crisis
- Various consultations have been published focusing on:
  - definition of “PRIPs”
  - product disclosure
  - point of sale regulation
- Point of sale issues now largely dealt with in MiFID II
- Draft regulation published on 3 July 2012

# Definition

- Regulation defines an “investment product” as:

  “an investment where regardless of the legal form of the investment the amount repayable to the investor is exposed to fluctuations in reference values or in the performance of one or more assets which are not directly purchased by the investor”

- Certain categories of product are expressly excluded including:
  - deposits with a rate of return determined by reference to an interest rate
  - “vanilla” securities that do not embed a derivative
  - insurance products offering only insurance benefits providing no surrender value exposed to fluctuations in underlying assets or reference values
  - occupational pension schemes covered by the Occupational Pensions Funds Directive or Solvency II
  - pension products for which a financial contribution from the employer is required by national law and where the employee has no choice of pension provider

# Key Information Document

- Regulation requires that where an investment product is to be sold to retail investors a Key Information Document ("KID") must be prepared
- Primary responsibility to draw up a KID will be placed on the investment product 'manufacturer', with scope for responsibility to extend to any entity that 'significantly' alters key features of the product (i.e. risk, return or costs)
- The guiding principle is standardisation so key information for each product is presented in a common way to promote comparability

# KID: Form

- No standard form or precedent has been provided. Instead, the Regulation sets out detailed requirements as to form and content

**Form of KID**

- Presented in a standalone document that is separate from any marketing materials
- Laid out in a way that is easy to read, using characters of "readable size"
- Clearly titled "**Key Information Document**" with the specific explanatory text as mandated in the Regulation
- Presented in one of the official languages of the member state where the product is being sold
- It should be "short" (though no limit specified) and be drafted in clear succinct and comprehensible language avoiding jargon and technical terms where possible
- The KID may be provided through hardcopy or via a website. Requirements for information presented on a website are set out in the Regulation

# KID: Content

## Content

- The over-arching principle as regards content is that it should be "*fair, clear and not misleading*" and the language must be "*clear, succinct and comprehensible*"
- The Regulation sets out a number of required sub-headings which must be presented in the document in the order set out below:
  - "**What is this investment?**" - provide details of the nature and main features of the investment product and the identity of the manufacturer
  - "**Could I lose my money?**" - include details of any guarantees or capital protection (and any relevant limits to these)
  - "**What is it for?**" - indicate the minimum holding period for the investment product, the expected liquidity profile (including the possibility of any divestments before maturity), the reward profile and the "market evolution" that is targeted
  - "**What are the risks and what might I get back?**" - set out the risk / reward profile of the investment product and detail any specific risks
  - "**What are the costs?**" - provide details of any costs associated with the product (both direct and indirect) to be borne by the investor (including summary indicators of these costs)
  - "**How has it done in the past?**" - include details of past performance and length of track record
  - "**What might I get when I retire?**" (only applicable to individual / personal pension products)

# Timing and Impact on Other Documents

## Timing

- The KID should be provided free of charge and "in good time" before an investment decision is taken, unless:
  - the retail investor chooses to conclude the transaction using a means of distance communication whereby providing the KID in good time is not possible; and
  - the person selling the investment has made this clear to the retail investor
- Where there are a series of successive transactions in relation to the same investment product, the obligation to provide a KID shall only apply to the first transaction

## Impact on Other Documents

- The Regulation makes it clear that whichever entity is preparing marketing materials should be conscious of the drafting contained therein, so as to ensure that there are no statements which contradict the contents of the KID, or diminish the KID's significance
- Marketing materials should also make clear that a KID is available to potential investors and provide details regarding how and where it can be obtained
- The Regulation currently anticipates the PRIPs KID requirements are additional to the issue-specific summary that will be required pursuant to amendments to the Prospectus Directive

# Liability and Sanctions

## Liability

- When a retail investor can demonstrate a loss resulting from its reliance on information in the KID, the burden of proof falls upon the manufacturer to show that the KID has been correctly drawn up in compliance with the Regulation

## Sanctions

- Member states must set down rules establishing appropriate sanctions for breaches of the Regulations which must at least include the possibility of:
  - an order prohibiting or suspending the marketing of an investment product
  - a public warning, identifying the person responsible and the nature of the breach
  - an order for the publication of a new version of the KID

# MiFID II

# MiFID II

- MiFID came into force in November 2007
- EU Commission Consultation Paper in December 2010
- Legislative proposals published in October 2011:
  - regulation (MiFIR)
  - recast directive (MiFID II)
- The use of two different legislative tools reflects a determination to achieve uniformity in some areas (via the Regulation) and flexibility in others (via the Directive)
- Themes of proposals include:
  - greater focus on investor protection (less choice)
  - move towards single market and single rule book
  - one size fits all
  - increased regulatory capture
  - more intrusive regulation
  - significant extension of scope for both products and market participants
  - major extension of transparency rules
  - more centralisation (many provisions now in regulation)
  - focus on enforcement and supervision

# Investor Protection

- Execution-only exemption
  - retained but narrowed
  - bonds and other forms of securitised debt must not embed a derivative or incorporate a structure which makes it difficult to understand the risks involved (ESMA to develop guidelines)
  - structured UCITS not now within exemptions
  - non-complex instrument becomes complex if coupled with credit arrangement
- Some narrowing of client categorisations:
  - ECP and professional client definitions tightened
- In providing investment advice, firms must state whether it is provided on an independent basis and whether on a broad or more restricted analysis of the market
- Firms providing independent investment advice or portfolio management will be prohibited from receiving third party inducements
- Best execution rules enhanced

# Market Infrastructure Reforms

- G20 – 2009 commitment:
  - "standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms where appropriate"
- MiFIR proposes that all derivatives subject to a clearing obligation under EMIR which are determined to be sufficiently liquid should be traded on a regulated market, MTF or OTF. This requirement is referred to as the "trading obligation"
  - or third country venue subject to meeting equivalence and other requirements
- ESMA to develop technical standards (and consult) in relation to "sufficiently liquid" criteria:
  - average frequency, average size and number of trades and profile of market participants to be considered
  - systemic risk irrelevant
  - ESMA to maintain website of derivatives subject to exchange trading obligation

# Organised Trading Facilities (OTF)

- **Organised trading facility:**
  - certain MiFID provisions currently limited to financial instruments admitted to trading on a regulated market or traded on MTFs or by systematic internalisers
  - OTF is under the latest Council compromise proposal defined as a multilateral system (not being a regulated market or MTF) in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances and derivatives are brought together to form a binding financial contract within the scope of MiFID
- Will catch organised trading outside current range of MiFID venues:
  - broker crossing systems and inter-dealer brokers
  - voice and electronic trading
  - not pure OTC transactions or bulletin boards

# Organised Trading Facilities (OTF) (cont.)

- OTFs to be subject to MiFID authorisation and conduct of business rules:
  - best execution
- Level playing field with some calibration
- Initial draft provided that client orders in an OTF are not permitted to be executed against proprietary capital of the OTF operator. The latest compromise proposal provides the OTF operator can only deal as principal in its system in the capacity as a liquidity provider by fulfilling orders initiated by clients or in response to clients' requests to trade or by hedging positions arising from fulfilling clients' orders.

# Pre- & Post-Trade Transparency

- Pre-trade transparency:
  - information about current trading opportunities
  - bid / offer prices
- Post-trade transparency
  - information relating to concluded trades
- EU Commission believes the same pre- and post-trade transparency requirements should apply to regulated markets, MTFs and OTFs
- Calibration for different types of instrument and trading
- Equity and equity-like instruments:
  - new requirements apply to all shares traded on a regulated market, MTF or OTF
  - rules also apply to depository receipts and other equity-like instruments
- Waivers to be applied on a consistent basis
- Details to be made public as close to real-time as technically possible

# Pre & Post-Trade Transparency (cont.)

- Non-equity markets:
  - regime extended to bonds, structured finance instruments, emission allowances and certain derivatives
  - to be subject to requirements, bonds and structured products must be admitted to trading on a regulated market or admitted to trading or traded on an MTF or OTF in respect of which a prospectus has been published
  - scope of waivers to be wider than for equity instruments
  - rules also to apply to OTC derivatives entered into by a systematic internaliser which are clearing eligible under EMIR and those traded on a regulated market, MTF or OTF

# PRODUCT INTERVENTION

# Product Intervention: EU

- EU Commission consultation paper on MiFID set out an intention to introduce the power to ban certain investment services and activities
- MiFIR provides that ESMA can take action to prohibit or restrict marketing, distribution or the sale of a financial activity, if addressing a threat to:
  - investor protection; or
  - the orderly functioning and integrity of financial markets; or
  - the stability of all or part of the EU's financial system; and
  - existing regulatory obligations are not sufficient and the relevant competent authorities have not taken appropriate action to deal with the threat
- ESMA must take into account any detrimental effect on the efficiency of markets that such action may have and the possibility of regulatory arbitrage

# Product Intervention: EU (cont.)

- Competent authorities will also have power to restrict marketing or sale of financial instruments in their member state on the same grounds as ESMA
- Action must be proportionate, taking into account:
  - nature of the risks identified;
  - level of sophistication of investors or market participants; and
  - likely effect of action on investors or market participants
- Relevant authority must consult with other relevant authorities likely to be affected by such action
- Action must not have a discriminatory effect on services or activities provided from another member state
- At least one month's notice must be given and details must be published on authority's website
- ESMA must seek to coordinate such action taken by competent authorities

# Product Intervention: UK

- Draft Financial Services Bill, amending the Financial Services and Markets Act 2000, was introduced to Parliament in January 2012
- Amendments would provide the Financial Conduct Authority **("FCA"), successor** to the Financial Services Authority, powers to make temporary product intervention rules to protect the interests of consumers and/or preserve competition
- Types of rules the FCA may make include:
  - requiring certain terms and conditions to be included or excluded;
  - requiring promotional material to be amended to ensure the consumer is not misguided;
  - limiting types of persons that can enter into certain types of agreement; and
  - placing restrictions or banning the sales and marketing of certain products
- Product intervention powers provided to the FCA are to be restricted to circumstances where, in the view of the FCA, measures are ***"necessary and expedient"*** to ensure consumer or competition protection.
  - It is being currently proposed that the scope for when powers may be exercised be extended to include market integrity as well

# Product Intervention: UK (cont.)

- In case of breach of any restriction placed on a product, the FCA may:
  - deem the agreement or obligation unenforceable against any counterparty;
  - recover any money or property transferred; or
  - require compensation to be paid

# Product Intervention: France

- Oct 2012 AMF position paper on marketing of complex products – covering marketing and sale of structured funds and complex debt securities to French retail investors – requires submission of marketing materials to AMF prior to distribution
- 4 criteria identified suggesting higher risk of client not understanding risks involved with product:
  - poor written/oral presentation of product's risks/pay-off profile
  - client's lack of familiarity with underlying assets
  - pay-off profile dependent on simultaneous occurrence of several conditions across asset-classes
  - high number (3 or more) of mechanisms for determining overall return on product
- If any of criteria satisfied and product offers less than 90% principal protection, materials must contain a prominent complexity/ unsuitability warning

# Product Intervention: Germany

- From July 2011, German investment services providers must provide investors in financial instruments with a product information sheet (PIB)
- Format not standardised, but to be no more than 2-3 A4 pages of information, in easily understandable form, on the pay-off profile of the product, the risks involved, how its pay-offs can be affected by market fluctuations and associated costs
- Like UCITS and PRIPs KIID, aim is to make key information easily accessible to investors in a form which enables comparability with other similar products

# Product Intervention: Belgium

- August 2011 FSMA consultation, following “voluntary” moratorium, on regulatory framework for retail distribution of structured products, including structured UCITS, insurance products and structured deposits
- 2 stated objectives of the regulation – enhancing transparency and reducing complexity
- Consulted on relationship between transparency and complexity, risk and complexity, concept of a risk threshold for retail structured products, uniform risk classifications, minimum standards for the organisation of secondary markets for the product, product intervention options

# Product Intervention: Italy

- 2009 CONSOB guidelines on distributing illiquid financial products to retail investors, including enhanced disclosure of "fair value" of each component, an overall liquidation value and the likelihood of the investor being able to sell or redeem (prior to maturity) at a "market price"
- Scope potentially includes bank-issued bonds, insurance financial products and OTC derivatives
- Required comparison of risk/return profiles with "more traditional, well known, low-risk financial products"

# Product Intervention: Denmark

- Since April 2011 mandatory risk labelling ("traffic lights") by firms of investment products sold or advised on by them
- Determined by combination of risk and complexity
  - green – small risk of losing the entire capital investment and product type not difficult to understand
  - yellow – risk of losing some or all capital investment but product type not difficult to understand
  - red – risk of losing more than the capital invested or product type difficult to understand
- Product categorisation by product label, so disparities within colour categories. Sale of advice on red category products requires specific training and qualifications

# AMENDMENTS TO THE PROSPECTUS DIRECTIVE AND REGULATION

# Background: Original Legislation

- Prior to 1 July 2012, the primary legislation governing prospectuses for securities issuances in the EU comprised the following:
  - the **Prospectus Directive** (2003/71/EC) (often referred to as the "**PD**"); and
  - the **Prospectus Regulation** (809/2004)
- The PD sets out the requirements (in terms of both form and content) for issuers to produce a prospectus, with the Prospectus Regulation providing for more detailed prospectus contents requirements
- Some of the main objectives of the PD were (i) to create a harmonised regime for drawing up, approving and distributing prospectuses; and (ii) create a single EU wide definition of what constitutes an 'offer to the public' (thereby also determining the circumstances in which transactional exemptions for non-public offers should apply)

# Background: Original Legislation (cont.)

- **Directive 2010/73/EU** ("**Amending Directive**") which significantly amended the PD, came into force on 1 July 2012
- Changes have also been made (and are proposed to be made) to the Prospectus Regulation through certain 'delegated regulations'. These are as follows:
  - Commission Delegated Regulation (EU) (486/2012) of 30 March 2012 (the "**March Amending Regulation**"); and
  - Commission Delegated Regulation (EU) (862/2012) of 4 June 2012 (the "**June Amending Regulation**")

# Exemptions from Publishing a Prospectus

- **Qualified Investor** - definition of Qualified Investor has changed in order to align it with the professional client and eligible counterparty definitions in the Markets in Financial Instruments Directive
- **Private placement exemption** – the number of non-qualified investors to whom an offer can be made in any one member state to has increased to 150
- **Minimum total consideration per denomination exemption** – has increased to €100,000
- **Types of securities exempted** – (i) securities offered in connection with mergers and divisions where an equivalent document has been created; (ii) dividends paid out to shareholders in the form of shares; and (iii) securities offered**,** allotted, or to be allotted to employees of the company

# Retail Cascade Regime

- Clarifies that financial intermediaries are under no obligation to create a new prospectus where the resale of securities, or final placement of securities takes place. This exemption is conditional upon:
  - the availability of a valid prospectus (i.e. a PD-compliant prospectus approved no earlier than 12 months prior to the resale or placement); and
  - the person responsible for creating the prospectus consenting to its use by written agreement

- The June Amending Regulation sets out two options for an issuer seeking to provide its consent:
  - the issuer can provide consent to one or more **specified** financial intermediaries (if known at the time that the prospectus is drawn up); or
  - the issuer can provide consent to **all** financial intermediaries

# Retail Cascade Regime (cont.)

- A new Annex XXX to the Prospectus Regulation sets out the nature of that consent and any restrictions which might exist. Each issuer must provide, *inter alia*, the following information:
  - express consent to the use of the prospectus and an acceptance of responsibility for the contents of the prospectus with respect to any subsequent sales (Category A);
  - an indication of the period for which consent is given (Category A) and the offer period in which resales/final placements by intermediaries can be made (Category C);
  - an indication of the member states in which intermediaries can rely on the prospectus (Category A);
  - any clear and objective conditions attached to the consent (Category C); and
  - a bold notice to investors that in the event of an offer by a financial intermediary that intermediary will provide information to investors on the terms and conditions of the offer at he time the offer is made (Category C)

# Retail Cascade Regime (cont.)

- For consent to specified intermediaries, the issuer must provide a list of their names/addresses (Category C) and an indication of how information on new intermediaries in the future will be published (Category A)

- For consent given to all financial intermediaries, there must be a notice in bold informing investors that any financial intermediary using the prospectus must state on its website that it is using the prospectus in accordance with the consent, and the conditions thereto (Category A)

# Form and Content (Base Prospectus)

## Mandatory Creation of a Prospectus

- Where a prospectus is mandated, the March Amending Regulation effects changes to the format and content of the base prospectus, final terms and the summary

## Base Prospectus

- The Base Prospectus must contain information to enable investors to make an informed assessment of the financial position of the issuer and any guarantor as well as the rights attaching to the securities
- The minimum content required in a base prospectus varies depending on the security being issued. Information to be included in the base prospectus and final terms has been categorized by the March Amending Regulation into:
  - **Category A** - items that must be included in full in the base prospectus and cannot be left in blank for later insertion in the final terms (e.g. risk factors, governing law and issuer credit ratings);
  - **Category B –** items where the general principles must be included in the base prospectus and only details not known at the date of approval of the base prospectus can be left blank for future insertion in the final terms; and
  - **Category C** - items where the base prospectus can contain a reserved space for later insertion in the final terms, relating to information not known at the date of approval of the base prospectus

# Form and Content (Base Prospectus) (cont.)

- To ensure that non-exempt offers/regulated exchange listings can only be carried out on the basis of an approved prospectus, the information contained in the base prospectus (approved by a competent authority) cannot be amended or replaced by the final terms

- However, the base prospectus can contain options for securities note information, with final terms specifying which options apply to the particular issuance

# Form and Content (Final Terms)

- Final terms must contain information, required by the securities note for the relevant type of security, specific to the individual issue
- Information contained in the base prospectus cannot be reproduced in the final terms and any new material information that may affect an investor's assessment of the issuer or the securities must be included in a supplement to the base prospectus (or a new prospectus)
- Information that may be included in the final terms is:
  - category B or C information for the relevant issuance;
  - reference to or replication of options already provided for in the base prospectus which are relevant to the individual issuance; or
  - on a voluntary basis, any further information set out in Annex XXI marked as "**additional information**" for example:
    - examples of complex derivatives securities and additional non-mandated provisions related to the underlying of the relevant security;
    - tranche or series number of the issue; or
    - countries where an offer to the public takes place or where admission to trading is pursued or into which the base prospectus has been notified, for the purpose of passporting

# Form and Content (Summary)

- A prospectus summary is always required, except for the admission to trading of non-equity securities with a denomination of at least €100,000
- It must be a short, self-contained summary of the most important information in the prospectus
- The summary information is prescribed by a new Annex XXII to the Prospectus Regulation, and must be set out in five mandatory tables:
  - an introduction and warnings section;
  - information about the issuer and any guarantor;
  - disclosure about the securities specifically;
  - key risks, including risks specific to the issuer, its industry and the securities; and
  - details of the offer being made

# Form and Content (Summary) (cont.)

- The Amending Directive also introduced a new concept referred to as **"Key Information**", which must be included in the summary
  - this includes essential information which is provided to investors to enable them to understand the nature and the risks of the issuer, guarantor and the securities that are being offered. Examples of information include:
    - risks associated with the issuer/guarantor (e.g. assets and liabilities), as well as risks that may attach to the particular security and any rights that the investor can exercise;
    - a summary of the terms the securities are offered on (including estimated expenses charged to the investor);
    - details of any admission to trading; and
    - detailed reasons for the offer and use of proceeds
- The summary must:
  - be drafted in clear language, presenting key information in an easily accessible and understandable way;
  - not be longer than 7% of the prospectus length, or 15 pages, whichever is greater; and
  - not contain cross-references to other parts of the prospectus

# Form and Content (Summary) (cont.)

- Where the summary is a summary of the content of the base prospectus for a programme**,** as opposed to an individual issuance, the summary **may** contain:
  - information included in the base prospectus;
  - options for information required by the Prospectus Regulation for the securities note (as opposed to the registration document) for the securities to be issued under the programme;
  - information required by such securities note left in blank for later insertion in the final terms
- Where the summary is a summary of an individual issuance under a programme, it must contain:
  - information from the base prospectus summary which is only relevant to that issuance;
  - the options contained in the base prospectus which are only relevant to that issuance; and
  - the relevant information contained in the final terms for the issuance which had been left blank in the base prospectus
- The summary of the individual issuance is to be annexed to the final terms

# Liability

- In the PD - the issuer and its directors, the offeror, any person requesting admission to trading, or the guarantor can be held liable for the contents of the prospectus
- Provisions for liability are dictated by individual member states
- No civil or criminal liability can be attached to any party solely on the basis of the summary, unless it is inaccurate or misleading or inconsistent, when read with other parts of the prospectus or it does not provide, when read with other parts of the prospectus, key information to aid investors when considering whether to invest

# UCITS AND ETF DEVELOPMENTS

# UCITS – Legislative Background

- The UCITS Directive was originally adopted in 1985, although legislation has evolved rapidly in the last few years. The changes made are part of a wider legislative package dedicated to rebuilding consumer trust in the financial markets
- **May 2009** – The Commission published a press release confirming the intention to enhance confidence in the UCITS regime in the wake of the Madoff fraud and the Lehman insolvency and to track developments for non-UCITS funds in Europe e.g. AIFM Directive
- **December 2010** – The Commission published a consultation paper focusing on the duties of a depository (safe-keeping, oversight and delegation), the remuneration of UCITS managers and how the relevant rules could be better harmonised
- **9 July 2012** – The Commission published a legislative proposal for UCITS V, making amendments to UCITS IV in respect of the depository function, remuneration and the sanctions regime (see more detail on the next slides)
- **26 July 2012** – The Commission published a consultation paper to determine whether further changes to the UCITS regime are required under a new UCITS VI. The areas focused on in the consultation include (amongst others) portfolio management, liquidity management tools, money market funds and long term investments (see later slide for more detail)

# UCITS V

- Rules on depositaries (amongst others):
  - **Cash monitoring** – intended to provide the depositary with an overview over all the assets of the UCITS
  - **Segregation requirement** - any financial instruments on a depositary's book held for a UCITS should be distinguishable from the depositary's own assets and be identifiable as belonging to that UCITS
  - **Conduct** - provisions on conduct and the avoidance of and management of conflicts of interest
  - **Delegation** – rules outlining the conditions under which a depositary's safekeeping duties can be delegated to a sub-custodian
  - **Appointment** - an exhaustive list of entities that are eligible to act as depositaries is provided
- Remuneration (amongst others):
  - **Policy** - management companies should establish and apply remuneration policies and practices that are consistent with (and promote) sound and effective risk management

# UCITS V (cont.)

- **Review** - the management body of the management company, in its supervisory function, must adopt and periodically review the general principles of the remuneration policy
- **Variable Remuneration** - guaranteed variable remuneration should be exceptional, occur only in the context of hiring new staff and be limited to the first year – also provisions regarding deferral, clawback, ratio of fixed to variable compensation, ratio of cash to non-cash compensation
- **Termination** - payments related to the early termination of a contract should reflect performance achieved over time and be designed in a way that does not reward failure

- Breach & Sanctions:
  - **Breach** – To try and achieve a minimum harmonisation of UCITS sanctioning regimes, Article 99A (1) provides a suggested list of the minimum circumstances in which sanctions should be able to be applied for breaches including: carrying on the business of a management or investment company without required approvals, failure to make certain notifications to the competent authority, or failure to comply with specified procedures or arrangements
  - **Sanction** - Article 99A (2) sets out possible minimum administrative sanctions for any of the relevant breaches, including: issue of a public statement indicating the breach, issue of a cease and desist order, withdrawal of regulatory authorisation or the imposition of bans or fines (up to pre-determined thresholds)

# Implementation of UCITS V

- Industry is currently in the process of preparing and submitting position papers with respect to the proposals. To date, responses have been filed from The European Fund and Asset Management Association (EFAMA – 17 September 2012), The European Banking Federation (EBF – 19 October 2012), and The Alternative Investment Management Association (AIMA – 22 October 2012)
- The Commission's proposal will be considered by the European Parliament and the Council – April 2013?
- Once agreement is reached, it is likely that member states will have around 2 years to transpose the amendments to the Directive into their national laws – suggesting that the new rules could be in place by the end of 2014
- The FSA is actively assisting ESMA with respect to the legislative process in order to produce guidelines and technical standards

# UCITS VI

- Recent work on shadow banking has highlighted a number of investment fund related issues and concerns, that have in turn prompted further analysis by the European Commission of the UCITS legislation (in particular, with respect to money market funds and the use of repo arrangements, which often form part of a fund's "efficient portfolio management" ("EPM")).
- The Commission's July 2012 consultation letter proposes discussion in respect of the following areas:
  - **Eligible assets**: UCITS portfolio management practices and investment policies are being evaluated in the light of complex strategies used to satisfy the UCITS Directive requirements to invest in eligible assets
  - **EPM techniques**: EPM techniques are being considered in the context of their transparency, potential for creating counterparty risk and the quality or reinvestment of collateral being employed
  - **OTC derivatives**: questions raised include whether OTC derivatives cleared through CCPs should be treated differently to uncleared derivatives for the purposes of counterparty exposure limits.

# UCITS VI (cont.)

- **Extraordinary liquidity management rules**: various liquidity issues are raised, including whether there should be a common framework for dealing with bottlenecks (i.e., large numbers of simultaneous redemption requests during a crisis) eg. defining the exceptional circumstances in which temporary suspension of redemptions is permitted
- **Depositary passport**: questions raised regarding the potential introduction of a cross border passport for the performance of UCITS depositaries
- **Money Market Funds (MMF)**: assessment of the need to strengthen the resilience of the MMF market in order to prevent investor runs and systemic risks
- **Long term investments**: questions raised regarding the need for a common framework that promotes long term investments (either by modifying the UCITS rules or via a standalone initiative) available to retail investors through funds
- **Addressing UCITS IV**: general assessment of the rules concerning the management company passport, master feeder structures, fund mergers and notification procedures and consideration of further alignment with the AIFM Directive

# European ETFs

# Regulatory Developments for European ETFs

Guidelines on Exchange-Traded Funds and other UCITS issues, published by ESMA in July 2012, provide key provisions for the regulation of European ETFs including:

- For index-tracking UCITS, disclosure in the UCITS prospectus of the following:
  - Clear description of the relevant index, including its composition
  - Details as to how the index will be tracked (eg physical or synthetic replication)
  - Anticipated level of tracking error and factors affecting the ability of the UCITS to track the index performance (transaction costs, divided reinvestment etc)

  And disclosure of the size of the tracking error in the UCITS' annual/semi-annual financial statements

# Regulatory Developments for European ETFs

- **ETF Identifiers** – All UCITS ETFs must carry within their name "UCITS ETF";
- **Secondary Market Liquidity** – If the trading price of the units ETF UCITS varies significantly from its NAV per unit, the ETF must provide appropriate direct redemption conditions. When direct redemption is offered a notice should be given to the relevant exchange;
- **Efficient Portfolio Management** – Any securities lent through a security lending arrangement should be able to be recalled at any time ETF must disclose operational costs/expenses of EPM that can be deducted from revenue delivered to the UCITS, as well as identity of payees and whether they are related to the UCITS manager/depositary. Any profits created by securities lending, after discounting operating costs, must be returned to the ETF;

# Regulatory Developments for European ETFs

- Collateral held for EPM/OTC derivative transactions must be:
  - highly liquid
  - valued daily
  - high quality
  - issued by an entity other than the counterparty
  - sufficiently diversified in terms of country, market and issuer (≤ 20% of a collateral basket)
  - in the case of cash collateral, invested only in short term European bank deposits, treasuries, reverse repos with regulated financial institutions and short term money market funds

# Regulatory Developments for European ETFs

- **Financial Indices Linked ETFs** – The full methodology of calculating the underlying index constitution should be provided to all investors to enable investor replication. Limitations on the indices that may be invested in, or disclosure, with regard to issues such as rebalancing frequency and diversification; and
- **Limits on Lending** – Previously contemplated caps on lending securities are not included in the guidelines.

ETFs, as “equity-like instruments”, will also subject to the pre and post trade transparency rules under the **MiFID II** provisions, as above.

# UK UCIS

# Restrictions on retail distribution of Unregulated Collective Investment Schemes ("UCIS")

- The FSA published a consultation paper in August 2012 relating to a proposed ban on the promotion of non-mainstream pooled investments (including UCIS and close substitutes – such as traded life policy investments, securities issued by SPVs and qualified investor schemes) to "ordinary" retail investors (i.e. retail investors other than sophisticated investors and high net worth individuals)
  - **Non-mainstream pooled investments**: funds characterised by unusual, speculative, complex assets, product structures, investment strategies and/or terms / features (potentially inc. UCIS) or which are illiquid or difficult to value
  - **UCIS**: A CIS where the operator has not applied for FSA authorisation or recognised scheme status.
- Concerns exist that (a) these products will in most cases not be suitable for ordinary retail investors and (b) many advisers are not complying with the current rules which restrict the promotion of UCIS schemes to ordinary retail investors
- FSA's new regulatory approach to propose intervention into the UCIS market in order to try and prevent consumer detriment occurring in the first place, rather than attempting to remedy it after it arises
- Changes to be implemented through the Unregulated Collective Investment Schemes and Close Substitutes Instrument 2012

# Restrictions on retail distribution of UCIS (continued)

Proposals include:

- Amendment of the financial promotion rules limiting the type of customer to whom UCIS and close substitutes can be marketed (primarily to only sophisticated investors and high net worth individuals);
- Guidance clarifying that personal recommendations amount to financial promotion (i.e. investment advice re UCIS is caught, as well as marketing);
- New rule requiring that firms maintain records of the basis on which a promotion has been made, and that intermediaries confirm the compliance of each financial promotion of non-mainstream pooled investments; and
- Update of the definition of "retail investment product"

Some market concerns (from the Joint Associations Committee - JAC):

- The additional regime is a disproportionate response that introduces additional and unnecessary complexity. The FSA's concerns would be better served by ensuring that the CIS regime is better understood and more widely policed (since many products, inappropriately sold to investors, should have fallen within the CIS regime and its restrictions on promotion)
- The definition of non-mainstream pooled investments is too wide and could catch products that are suitable and desirable for ordinary retail investors

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