ALERT MEMORANDUM

EU Commission Proposals to Harmonize the Cross-border Distribution of Funds and Define "Pre-marketing"

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The European Commission has published legislative proposals for a Regulation and a Directive amending the current regulatory frameworks for cross-border distribution of funds within the European Economic Area ("**EEA**"). While the proposals are in principle designed to ensure a level playing field among different categories of funds, and to facilitate the cross-border distribution of funds, they have the potential to create the opposite effect for non-EEA funds and fund managers by limiting the scope of permitted "pre-marketing" to EEA investors.

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The proposals form part of the EU Capital Markets Union action plan, which is being implemented through various proposals designed to stimulate capital markets activity within the EU/EEA, including via removal of perceived regulatory barriers. As with many recent EU proposals, however, the beneficial outcomes for cross-border activity are focused towards EEA firms and markets, with no apparent parallel efforts to liberalise cross-border distribution of third country (non-EEA) funds and or by non-EEA fund managers. Indeed, if implemented in their current form, the proposals have the potential to impede further the ability of non-EEA sponsors to target EEA investors. This is due to the restrictive proposed definition of "pre-marketing" and its interaction with the concept of "reverse solicitation", which would limit managers' ability to gauge and respond to investor interest.

Although the specific restrictive conditions attached to "pre-marketing" technically apply only to EEA managers, the "pre-marketing" concept has general application and it therefore seems likely that it will be applied consistently to both EEA and non-EEA fund managers. The proposed changes are particularly problematic when combined with the restrictive character (or in some cases non-existence) of national private placement regimes in some EEA member states, together with the continuing absence of any marketing passport system for third country funds and fund managers.

1. Introduction

Collective investment funds are regulated within the EEA under two EU directives: the Directive on Undertakings for Collective Investment in Transferable Securities ("**UCITS**"), which governs the operation and distribution of retail funds, and the Directive on Alternative Investment Fund Managers ("**AIFM**"), which sets a pan-European framework in relation to the authorization, supervision and oversight of managers of all other types of funds ("**AIFs**"). This briefing focuses on the potential impact on cross-border AIF markets, particularly for non-EEA AIFs and AIFMs.

The Commission's Proposals take the form of a Directive and a Regulation, which introduce a series of new legal and regulatory requirements, and amend the AIFM and UCITS Directives. They follow a series of consultations: the Green Paper on Capital Markets Union, which was published on February 18, 2015, and the Call for Evidence on the EU regulatory framework for financial services, which was published on September 30, 2015. Following these two general consultations, a public consultation addressing the cross-border distribution of investment funds was published on June 2, 2016.

The proposals contain various initiatives designed in principle to reduce regulatory barriers, including:

- Enhancing the transparency of national marketing requirements at both the national and EU level;
- Harmonizing the definition of "pre-marketing" and its interaction with the "reverse solicitation" concept in the AIFM Directive;
- Providing for greater transparency and consistency in relation to regulatory fees; and
- Harmonizing the procedures and requirements for updating notifications and de-registration from marketing in individual member states.

The Commission argues that these reforms will make it more likely that funds will be marketed cross-border, thereby improving competition, reducing market fragmentation and providing more choice to EEA investors.

If the "pre-marketing" concept is introduced as proposed, however, EEA investors may face reduced choice where access to non-EEA AIFs and AIFMs is concerned. It is also disappointing for EEA investors and non-EEA AIFMs that the focus on removal of regulatory barriers at the pan-EEA level has not been combined with any measures designed to harmonise marketing under the national private placement regimes ("**NPPR**"), which vary significantly across member states in their availability, the process and the conditions attached.

Nor do the proposals contain any attempt to revive earlier measures towards implementation of the so-called "third country passport" originally contemplated by the AIFM Directive for introduction in 2018 as a route to more integrated access for third country AIFMs. Initial progress made by EU authorities in this area appears to remain stalled following initial positive steps in 2015-16. If the current situation on third country access continues and the recent proposals are implemented, the environment for non-EEA sponsors could prove increasingly restrictive, both for connecting with existing EEA investors and for testing interest in new EEA jurisdictions.

2. Pre-marketing

The current AIFM Directive provides a definition of "marketing" as "*a direct or indirect offering or placement at the initiative of or on behalf of the AIFM*". AIFMs are required to notify local regulators before marketing their funds to EEA investors, including on a cross-border basis under the EEA passport and from outside the EEA under NPPR. There is, however, no consistency of approach across the EEA on what (if any) communications may take place with investors without triggering a "marketing" notification obligation. In some member states, AIFMs may have extensive discussions and share draft fund documents with investors before triggering a notification requirement, whereas others class all fund-specific communications as "marketing" sufficient to require notification.

The Commission intends to address the current diverse approach to what activities constitute "pre-marketing" across member states by defining that term within the amended AIFM Directive, and by setting out a series of conditions under which an EEA AIFM can engage in pre-marketing activities. It is unfortunate, however, that the Commission has chosen to pursue harmonization in line with the most restrictive of the current national approaches and to introduce this as the mandatory benchmark across the EEA.

The recitals to the Directive provide that "*during the course of pre-marketing, investors are unable to subscribe to the units or shares of an AIF because the fund does not exist yet, and no offering documents, even in a draft form, should be permitted to be distributed to potential investors during this stage*".

The Commission proposal is to define "pre-marketing" as a "*direct or indirect provision of information on investment strategies or investment ideas by an AIFM or on its behalf to professional investors domiciled or registered in the Union in order to test their interest in the AIF which is not yet established*". Pre-marketing is permitted to take place prior to the formal notification of the fund to local regulators, except when the information presented to potential investors:

- relates to an established AIF;
- contains reference to an established AIF;
- enables investors to commit to acquiring units or shares of a particular AIF; or
- amounts to a prospectus, constitutional documents of a not-yet-established AIF, offering documents, subscription forms or similar documents whether in a draft or a final form allowing investors to take an investment decision.

Although the harmonization of the treatment of pre-marketing across member states is desirable in principle, the proposed approach is unhelpfully narrow and not without ambiguities. Under the proposed definition of pre-marketing, post "establishment" of the AIF, the distribution of teasers and pitchbooks or any other information that relate or contain a reference to the existing AIF would constitute "marketing", even though at that stage investors are not able to subscribe for interests in the AIF. The reference to an AIF being "established" is also unclear. Does it refer to the legal establishment of the AIF vehicle, or its first closing with investors? It is common practice to start the establishment process of the AIF during the pre-marketing stage under a short form limited partnership agreement, for example, and if an AIF would be considered as "established" from that point for the purpose of the proposed definition of pre-marketing, then the scope of pre-marketing would be narrowed down even further.

The proposed narrow definition would remove the valuable flexibility offered in a number of member states (including the UK) in which notification to the UK regulator is not required until a final or substantially final private placement memorandum or constitutional documents are circulated. Under the new proposals, this approach would no longer be available and sponsors would need to notify and obtain the consent of national regulators at a much earlier stage than is currently the case. The outright removal of the ability to test investor interest in a particular fund before committing to a marketing notification would prove even more challenging in those jurisdictions that have long waiting periods for regulatory approval to market funds under the NPPR, as non-EEA AIFMs would need to complete the approval process before commencing any fund-specific discussions with local professional investors. It should be noted that it is possible that these reforms will not be enacted until after the UK's exit from the EU; and it is therefore conceivable that UK requirements and practice may diverge from that taken in the EU/EEA. UK AIFMs are also likely to be placed in a more restrictive position following transition to third country AIFM status.

3. Reverse solicitation

The proposals also contain further provisions to specify that investments made by professional investors in (i) an established AIF following the permitted pre-marketing; or (ii) an AIF managed or marketed by the EEA AIFM that had engaged in pre-marketing of a not-yet established AIF with similar features, shall be considered the result of marketing. Whilst it was already market practice to consider that

pre-marketing a specific fund to investors precludes subsequent reliance on reverse solicitation with respect to that fund, the proposal would also preclude any reverse solicitation with respect to any fund with the same or a similar strategy as the one that was the subject of the pre-marketing. This would appear to restrict the availability of reverse solicitation for any investors in prior funds, which tends to be a key source of genuine reverse enquiry requests. This proposed change also has the potential to limit further the ability of non-EEA AIFMs to reach investors in "closed" jurisdictions (with no viable NPPR) for which reverse solicitation is currently the only access route.

4. Other proposed changes

The proposed Regulation also sets out a number of other changes, including:

- New and enhanced requirements for marketing communications, which will require that (i) the communications are identifiable as such, (ii) they present the risks and rewards of purchasing units or shares of AIFs in an equally prominent manner and (iii) all information included in marketing communications is fair, clear and not misleading;
- Provisions relating to proportionality and transparency of regulatory fees and charges levied by national regulators, which currently vary and are in some cases perceived to be excessive and pose difficulties for smaller fund managers;
- Specific obligations for the provision of local subscription and redemption facilities to retail investors (where applicable), similar to the requirements under the UCITS Directive; and
- A new regime for "de-registration" of AIFs from national registers in circumstances where conditions on *de minimis* investor participation and others are met.

It is unclear at this stage whether and how far these additional requirements will be applied to non-EEA AIFMs.

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