Fund distribution in Europe – navigating the regulatory minefield

A brief background

Despite the European Commission's efforts at harmonising fund distribution within the EU, it remains a patchwork of regulation, falling between the UCITS Directives, AIFMD, PRIIPs, the Cross-Border Distribution Directive, MiFID and SFDR.

The applicable rules will vary depending on the mechanism of distribution, target market, geographic scope and type of fund. Added to which, the specific rules in each case may stretch to myriad implementing provisions, so advice should be taken.

This overview attempts to summarise the overarching principles and flag potential tripwires introduced by the Cross-Border Distribution Directive and SFDR.

UCITS/AIFMD/MiFID interplay

The first distinction to note is that UCITS regulates the *product*, whereas AIFMD regulates the *manager* (AIFM), although it should be noted that alternative investment funds (AIFs) may also be regulated at the product level, depending on the particular treatment of fund types in a given member state (e.g. SIFs and QIAIFs).

MiFID

The above distinction is pertinent when it applies to distribution, as it triggers *when* a promoter will also need to consider the application of MiFID to its distribution activities. Insofar as applicable to fund distribution, MiFID touches upon advice and execution. Of course, MiFID applies to a range of financial services and would also apply where a promoter is promoting a managed account solution to its clients, since the operation of a managed account would be a MiFID activity.

AIFMD

AIFMD allows for an AIFM to make a passporting application for each AIF that it manages, so can undertake distribution activities in relation to each AIF. However, if an AIFM goes out to market with a number of AIFs at the same time, then its activities may fall into MiFID if its activity includes an element of advice (e.g., a consideration of a client's risk appetite and consequential recommendation of a particular product to meet that need). Alternatively, if a conversation around a particular AIF turns towards a consideration of a managed account, that would start to fall within MiFID.

UCITS

Technically, if passported, a UCITS can rely on execution-only subscription, so there may be a situation where no distribution activity has occurred. In practice, distribution of UCITS tends to fall within MiFID, and distributors must also concern themselves with client classification and distribution of information. The distribution of UCITS has been positively impacted by the Cross-Border Distribution Directive, with the removal of the requirements for domestic facilities agents, though promoters should familiarise themselves with the forthcoming change to require a PRIIPs KID rather than a UCITS KIID, to harmonise retail distribution of UCITS with retail AIFs.

Revisiting the cross-border distribution directive

While we tend to use the term "Cross-Border Distribution Directive", it is actually a package of changes contained in both a Directive and a Regulation (the Regulation being required to amend existing Regulations). The main regulatory changes are to AIFMD and the UCITS Directive.

The Cross-Border Distribution Directive makes a number of changes to the distribution of funds in the EU. Some of these are clearly beneficial, such as allowing facilities agent services without a physical presence in a member state, whereas others are more questionable, such as the impact of the new pre-marketing notification regime, and new requirements around marketing communications.

Before we focus on pre-marketing and the new requirements around marketing communications, it's worth noting that the Directive also gave the market an invaluable tool for fund distribution. ESMA is now required to publish summaries and hyperlinks to the websites of competent authorities where they publish complete and up-to-date information on the applicable national laws, regulations and administrative provisions governing marketing requirements for AIFs and UCITS. This page is worth bookmarking.

Pre-marketing

In order to purportedly simplify the AIF launch process, a streamlined "pre-marketing" notification was introduced. In short, where a firm is considering launching an AIF and wishes to sound-out prospective investors, this activity constitutes "pre-marketing" that must be notified to the AIFM's home state regulator within two weeks of the pre-marketing having commenced.

The notification must specify where and for what period the pre-marketing is taking place, with a brief description of the pre-marketing and investment strategy of the proposed AIF. Once AIFMs comply with the notification requirement, they receive the benefit of regulatory coverage for up to 18 months to speak to prospects in the EU.

It should be noted that an AIFM is required to make the notification for the proposed AIF, and it is the AIFM that receives the benefit of the regulatory coverage. As such, there is an argument to say that this is more of a burden than a benefit, since there were already mechanisms for firms to promote AIFs that had not yet launched, and it has the consequence of removing one of these mechanisms.

Reverse solicitation

Reverse solicitation had been in the EU's regulatory crosshairs for some time. It should never form the basis for a distribution strategy but had nonetheless been a useful tool for accessing investors in certain jurisdictions. Now, any subscription made from EU investors within 18 months of a pre-marketing notification will be considered the result of such pre-marketing, which essentially means it could not be classified as reverse solicitation during that time and would therefore require a formal passporting in the event that the EU AIF is indeed launched and a subscription is made from that member state. Reverse solicitation is still permitted in certain circumstances, although its scope has been narrowed and it remains very much in the regulatory spotlight.

Private placement

The European Commission is considering whether the national private placement regime (NPPR) creates an unlevel playing field in some member states by affording less regulated non-EU fund managers the same level of market access as their EU (AIFM) counterparts. While there are no specific provisions on private placement, the Cross-Border Distribution Directive included a recital which states that national rules implementing its measures "in particular, harmonised rules on pre-marketing, should not in any way disadvantage EU AIFMs vis-à-vis non-EU AIFMs". As a consequence, promoters relying on NPPR will have to make similar NPPR style pre-marketing applications in each target member state (i.e. in the same way that they can't rely on a marketing passport, they can't rely on a single point of entry for NPPR pre-marketing).

De-notification of marketing of an AIF or UCITS in member state

Where a UCITS or open-ended EU AIF has been marketed in a member state and the promoter wishes to cease marketing the UCITS or AIF, it must send a notice of de-notification to its home regulator relating to the activities in the member state in question.

It must also make a blanket offer to investors in that member state to repurchase or redeem (free of charge or deductions) all units or shares of the UCITS or AIF being de-notified. This offer must be publicly available for at least 30 working days and addressed individually to all investors in the member state in question. It should be noted that there is currently a degree of divergence in interpretation between the various national competent authorities about what *medium, including by electronic means,* would be *customary for marketing AIFs/UCITS,* so promoters should take legal advice on the specifics around an EU marketing denotification.

Marketing communications and the ESMA guidelines

The Cross-Border Distribution Directive had a staggered implementation. While there was a degree of coverage when it came into force on 2 August 2021, there was little fanfare for the second leg of its application, which came in from 2 February 2022 with ESMA's guidelines on marketing communications under the Regulation on cross-border distribution of funds (the Guidelines).

A UCITS or an EU AIFM must now ensure that all marketing communications to investors are identifiable as such, describe the risks and rewards of purchasing units or shares of a UCITS or an AIF in an equally prominent manner, and – crucially - all information included in marketing communications must be fair, clear and not misleading. This is a standard that already applied to retail communications in the EU but has been extended to all EU AIFM communications.

The practical impact for promoters operating on a delegated management basis from a third party AIFM or ManCo platform in the EU, is that they must prepare for additional lead time before issuing marketing communications, and work with the third-party manager on appropriate policies and processes around the content, approval and issue of marketing communications.

What is a marketing communication?

The Guidelines are not prescriptive rules on what should be considered but they "apply to all marketing communications addressed to investors or potential investors for UCITS and AIFs, including when they are set up as EuVECAs, EuSEFs, ELTIFs and MMFs". They go on to give examples of what *should* be considered a marketing communication, which includes all forms of advertising, regardless of the medium and method of publication (such as social media) and includes direct correspondence with investors. They also apply to communications issued by third parties.

In terms of what is *not* considered to be a marketing communication for these purposes, corporate information at the level of the manager or promoter would be out of scope, as would legal information (as this is governed elsewhere), but should come as something of a relief to promoters is that pre-marketing information is expressly out of scope.

Summary of the requirements

- ***The identification as such of marketing communications***

Linking to the point on pre-marketing communications being excluded, marketing communications are only permitted where the UCITS or AIF in question has been approved for distribution in a given member state. At that point, the requirement for identification should be self-explanatory, but the applicable communication should be clearly labelled as a "marketing communication" such that any person can easily identify it.

Additionally, marketing communications should include a disclaimer along the lines of the following:

"This is a marketing communication. Please refer to the [prospectus of the [UCITS/ AIF/EuSEF/EuVECA]/Information document of the [AIF/EuSEF/EuVECA] and to the [KIID/KID] before making any final investment decisions."

However, ESMA also accepts that certain mediums, such as social media, may not allow for this, so shorter identification of "Marketing Communication" or even "#MarketingCommunication" will suffice.

- ***The description of risks and rewards in an equally prominent manner***

Marketing communications that reference any potential benefit of purchasing units or shares of an AIF or units or shares of a UCITS should be accurate and always give a fair and prominent indication of any relevant risks. This equally prominent disclosure of risks and rewards should be assessed in relation to both the presentation and the format of these descriptions.

Practically, this means that firms should consider factors such as font size, colour and positioning, rather than simply burying risks at the bottom of a document in a grey box.

- ***The fair, clear and not misleading character of marketing communications***

As mentioned above, this is a standard that already applied to retail clients under MiFID. It now applies to all fund marketing communications and investor groups, although the level of information and the way that the information is presented may be adapted to whether investment in the promoted fund is open to retail investors (i.e. UCITS or retail AIFs), or to professional investors only (i.e. non-retail AIFs). So, for example, it would be expected that communications to retail investors would not include excessive technical language, but those to professional investors could retain technical terms.

Prudent firms should already be ensuring that information presented in the marketing communications is consistent with the legal and regulatory documents of the fund, but this is now a regulatory obligation, and care should be taken beyond the basics, to think more about recommended holding periods, risks and rewards, costs, past and expected future performance, and sustainability-related aspects of the investment. The requirement is to ensure consistency, rather than a reproduction of the legal terms. Furthermore, firms should avoid cross-referencing to the legal documents.

- ***Information on risks and rewards***

Further requirements remind firms that risk profiles should be consistent with KIID or KID disclosures, and illiquid retail funds should clearly state liquidity risks.

- ***Information on costs***

Marketing communications should include an explanation to allow investors to understand the overall impact of costs on the amount of their investment and on the expected returns.

- ***Information on past performance and expected future performance***

What must be disclosed will depend on the form of performance reporting (periods, reference data, material events etc), with additional obligations around any simulated reporting. Again, one would expect performance reports to already caveat along the lines that "Past performance does not predict future returns", but this is now required language.

There are additional requirements around expected future performance, such as being based on reasonable assumptions supported by objective data; as with simulated data, promoters should take additional care in relation to such modelling.

- ***Information on sustainability-related aspects***

Helpfully, there is additional guidance to incorporate the additional requirements of the Sustainable Finance Disclosure Regulation (SFDR). In particular, as SFDR requires certain website disclosures, any marketing communication that refers to the sustainability-related aspects of the investment in the promoted fund should link to the website detailing the additional information.

Furthermore, as part of the drive against greenwashing, information on the sustainability-related aspects of the promoted fund should not outweigh the extent to which the investment strategy of the product integrates sustainability-related characteristics or objectives.

SFDR – changes to investor suitability requirements

The final regulatory challenge for fund distribution relates to the impact of the Sustainable Finance Disclosure Regulation (SFDR) on the application of the MiFID suitability guidelines.

ESMA's updated guidelines on certain aspects of the MiFID II suitability requirements were published in September 2022, requiring investment firms to integrate sustainability factors, risk and preferences into certain organisational requirements and operating conditions. While these updates don't formally apply until August 2023, firms are expected to make efforts to comply with the requirements ahead of this date.

The guidelines principally address situations where services are provided to retail clients, and only apply to professional clients "to the extent that they are relevant", taking proportionality principles into account.

The key point to note here is that, while the guidelines directly apply to MiFID firms, such as distributors, their application has knock-on consequences for product providers, whether in the EU or not, as they impact the products that may be made available to end investors in the EU.

Where MiFID firms are making their suitability assessments on end clients, they must now also ask them about their sustainability preferences as part of the suitability assessment and ensure that investment advice and investment decisions match those preferences. If a client expresses sustainability preferences that do not match the products available, then a product cannot be sold to them.

The challenge here is that the concepts under SFDR are esoteric at best, so while this poses significant challenges to distributors who are required to explain these to retail clients, there is also a risk that these clients will err towards a greater proportion of sustainable investment than exists in the wider investment universe (one could argue that this is by design), and therefore opt themselves out of investment choices that are either not aligned with the EU Taxonomy, not defined as sustainable investments for the purposes of SFDR, or don't happen to consider principal adverse impacts (PAIs, as defined under SFDR).

While it will be possible for clients to express *no* sustainability preferences, and therefore keep their investment universe as broad as possible, this seems unlikely given the other obligations that MiFID firms have towards those clients in this area.

Key contact

Mark Shaw
Partner
Investment Funds – London / Luxembourg
+44 7899 064 272
mark.shaw@pinsentmasons.com

Pinsent Masons LLP is a limited liability partnership, registered in England and Wales (registered number: OC333653) authorised and regulated by the Solicitors Regulation Authority and the appropriate jurisdictions in which it operates. Reference to "Pinsent Masons" is to Pinsent Masons LLP and/or one or more of the affiliated entities that practise under the name "Pinsent Masons" as the context requires. The word "partner", used in relation to the LLP, refers to a member or an employee or consultant of the LLP or any affiliated firm, with equivalent standing. A list of members of Pinsent Masons, those non-members who are designated as partners, and non-member partners in affiliated entities, is available for inspection at our offices or at www.pinsentmasons.com © Pinsent Masons
For a full list of the jurisdictions where we operate, see www.pinsentmasons.com