CROSS BORDER DISTRIBUTION OF COLLECTIVE INVESTMENT FUNDS

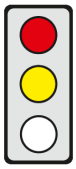
cep**PolicyBrief** No. 30/2018

Centrum für Europäische Politik

KEY ISSUES

Objective of the Directive and Regulation: The cross border distribution of investment funds is promoted.

Affected parties: Investors, investment funds, national competent authorities and ESMA.



Pro: (1) The proposal, that managers of UCITS and retail AIFs may no longer be required to be "physically present" in host Member States, reduces distribution costs.

Contra: (1) In a market economy, there is no compelling reason why the law should determine the conditions under which an investment fund manager may de-notify his funds.

(2) Defining “pre-marketing” activities will not materially increase the distribution of AIFs to professional investors, since the admissible scope of “pre-marketing” activities is very limited.

(3) The requirement for supervisory fees to be proportionate to expenditure and effort falls outside the EU’s harmonisation competence.

The most important passages in the text are indicated by a line in the margin.

CONTENT

Title

Proposal COM(2018) 92 of 12 March 2018 for a **Directive** amending Directive 2009/65/EC of the European Parliament and of the Council and Directive 2011/61/EU of the European Parliament and of the Council **with regard to cross-border distribution of collective investment funds**
Proposal COM(2018) 110 of 12 March 2018 for a **Regulation on facilitating cross-border distribution of collective investment funds** and amending Regulations (EU) No 345/2013 and (EU) No 346/2013

Brief Summary

- **Definitions, context and objectives**
  - In the EU, there are two categories of collective investment funds:
    - Undertakings for collective investment in transferable securities (UCITS), which are investment funds aimed at retail investors; they are covered by the UCITS-Directive [2009/65/EC];
    - Alternative investment funds (AIFs), which are investment funds usually aimed at professional investors, although Member States may also allow them to be offered to retail investors (retail AIFs); they are covered by the AIFM-Directive [2011/61/EU].
  - According to the Commission, the EU investment funds market is still largely fragmented along national lines: In June 2017, 70% of assets under management in the EU were held by investment funds that were only active in the country of origin. Only 37% of UCITS and 3% of AIFs were registered for distribution in more than three Member States. [Explanatory Memorandum p. 2, Directive and Regulation]
  - The Commission wants to reduce the existing regulatory barriers to the cross-border distribution of investment funds in the EU [Explanatory Memorandum p. 1, Directive and Regulation] and therefore proposes to
    - prohibit Member States from requiring a physical presence to be set up on their territory, by managers of UCITS and retail AIFs operating across borders,
    - introduce common rules under which managers of UCITS and EU-AIFs may discontinue (“de-notify”) the marketing of units or shares of their funds in a given Member State,
    - introduce a definition of and conditions for “pre-marketing” activities by managers of AIFs; i.e. activities to test professional investors’ interest in certain investment concepts and strategies,
    - harmonise some regulations concerning “marketing rules”, and
    - introduce rules on the proportionality and transparency of supervisory fees and charges.
- **Ban on Member States requiring the “physical presence” of UCITS and retail AIFs on their territory**
  - Managers of UCITS and retail AIFs must have “facilities” in every Member State where they market their services in order to process subscriptions, payments and repurchase or redemption orders.
  - However, host Member States must not require a “physical presence” within their jurisdiction. Electronic or other means of distance communication may be used instead. [Art. 1 (5) and Art. 2 (7), Recitals 5 and 6, Directive]

Authors: Dr. Martina Anzini and Philipp Eckhardt| anzini@cep.eu
cep | Kaiser-Joseph-Straße 266 | 79098 Freiburg |Germany | Phone +49 (0)761 38693-107 | www.cep.eu

- **Establishment of specific conditions for "de-notification" of the marketing of UCITS and EU-AIFs**
  - Managers of UCITS and AIFs may discontinue ("de-notify") the marketing of their funds in a given Member State.
  - However, they may do so only if, in the respective Member State, [Art. 1 (7) and Art. 2 (5), Directive]
    - a maximum of 10 investors together hold no more than 1% of the assets under management,
    - they publish and make an individual offer to all investors valid for at least 30 working days to repurchase, free from any charge or deduction, their units or shares, and
    - they make public through "appropriate means" the intention to discontinue their marketing activities.

- **Definition and conditions for "pre-marketing" activities by managers of AIFs**
  - "Marketing" is an offering or placement of units or shares to or with EU-investors by a manager of an AIF [Art. 4 (1) (x), AIFM Directive]. Marketing activities entail a costly notification procedure [Chapter VI, AIFM Directive].
  - In order to establish a clear-cut demarcation, "pre-marketing" is now defined as "a direct or indirect provision of information on investment strategies or investment ideas" to professional investors by a manager of an AIF [Art. 2 (1), Directive].
  - Managers of EU-AIFs may only engage in "pre-marketing" activities, if these activities [Art. 2 (2), Directive]
    - do not relate to an established AIF or even contain reference to an established AIF,
    - do not "enable investors to commit" to acquiring units or shares of a particular AIF,
    - do not entail the provision of documents – i.e. prospectuses, offering documents, subscription forms – allowing investors to undertake a commitment to invest.
  - Managers of AIFs must notify the competent authorities in their home Member State of their "marketing" activities [Chapter VI, AIFM Directive]. They do not have to give notification of "pre-marketing" activities [Art. 2 (2), Directive].
  - The subscription to units and shares of an AIF by a professional investor after "pre-marketing" is considered to be the result of "marketing". [Art. 2 (2), Directive]
  - The pre-marketing rules also apply to European Venture Capital Funds (EuVECA) and European Social Entrepreneurship Funds (EuSEF) [Art. 12 and 13, Regulation].

- **Marketing rules**

  General principles on marketing communications
  - Managers of UCITS and AIFs must ensure that marketing communications addressed to investors are identifiable as such, present the risks and rewards of investing in UCITS and AIFs in an "equally prominent" manner and are "fair, clear and not misleading" [Art. 2 (1), Regulation].
  - Marketing communications on a UCITS must not contain information that conflicts with information available in the UCITS prospectus or the UCITS "key investor information" document or diminishes their significance. They shall include references to the prospectus and the key investor information document. [Art. 2 (2), Regulation] The same applies to AIF marketing communications in so far as they have to publish a prospectus or a key investor information document [Art. 2 (4), Regulation].
  - The European Securities and Markets Authority (ESMA) shall issue guidelines on the requirements for marketing communications [Art. 2 (5), Regulation].

  Systematic notification of marketing communications
  - Competent authorities may require managers of UCITS and retail AIFs to provide "systematic" notification of their marketing communications in order to verify their compliance with the relevant national marketing requirements (Art. 5 (1) and (3), Regulation, Explanatory Memorandum p. 8].
  - Competent authorities shall [Art. 5 (1) (2) and (4), Regulation]
    - decide within 10 working days whether a marketing communication has to be altered,
    - apply and publish applicable procedures ensuring transparent and non-discriminatory treatment regardless of the origin of the UCITS or AIF, and
    - report annually to ESMA about their decisions to reject marketing communications or to require their alteration.
  - Member States cannot make the marketing of UCITS and retail AIFs conditional upon compliance with the systematic notification regime [Art. 5 (1), Regulation].

- **Proportionality and transparency of supervisory fees**
  - Where competent authorities levy fees or charges on managers of UCITS or AIFs, these must be "proportionate" to the expenditure relating to authorisation and registration and to supervisory and investigatory tasks carried out by the authority [Art. 6 (1), Regulation].
  - Competent authorities have to set up central databases listing the fees or charges and their calculation methodologies. They have to notify ESMA about that information. ESMA has to establish its own central database on the fees, charges and calculation methodologies. [Art. 7 (1) and (2), Art. 8 and 9, Regulation]

Main Changes to the Status Quo

- Until now, EU-rules for the establishment of "facilities" only applied to managers of UCITS. In future, they will also apply to managers of retail AIFs. In future, Member States can no longer prescribe "physical presence".
- Until now, EU-rules only related to the notification of UCITS and AIFs wishing to conduct business in another Member State. In future, there will be also EU-rules on the "de-notification" of UCITS and AIFs.
- Until now, EU-rules only related to the "marketing" activities of managers of AIFs. In future, there will also be EU-rules on the "pre-marketing" activities of managers of AIFs.
- Until now, the EU-rules on marketing communications were established by a Directive, only applied to UCITS and were not very detailed. The new rules are established by a Regulation, also apply to AIFs and are more detailed.
- Until now, Member States could require managers of UCITS to give notification of marketing communications. In future, they can also require managers of retail AIFs to do so.
- The Regulation introduces harmonised rules on the proportionality and transparency of fees and charges.

Policy Context

Both proposals are to deepen the Capital Markets Union ("CMU") and are to further implement the CMU action plan [COM(2015) 468, see cep**PolicyBrief**] in accordance with the CMU Mid-Term Review [COM(2017) 292].

Statement on Subsidiarity by the Commission

According to the Commission, the functioning of the market for the services of investment funds is prevented by national regulatory barriers to their cross-border distribution, which cannot be removed by single Member States.

Legislative Procedure

12 March 2018	Adoption by the Commission
Open	Adoption by the Parliament and Council, publication in the Official Journal of the EU, entry into force

Options for Influencing the Political Process

Directorates General:	Directorate-General for Financial Stability, Financial Services and Capital Markets Union
Committees of the European Parliament:	Economic and Monetary Affairs (leading), Rapporteur: Wolf Klinz (Group of the Alliance of Liberals and Democrats for Europe, Germany)
Federal Germany Ministries:	Finance (leading)
Committees of the German Bundestag:	Finance (leading)
Decision-making mode in the Council:	Qualified majority (acceptance by 55% of Member States which make up 65% of the EU population)

Formalities

Competence:	Directive: Art. 53 para. 1 TFEU (Right of Establishment) Regulation: Art. 114 TFEU (Internal Market)
Type of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

The Commission's aim of reducing existing barriers to the cross-border distribution of investment funds is to be welcomed. Its proposals are, however, not fully satisfactory.

The proposal that managers of UCITS and retail AIFs can no longer be required to be "physically present" in host Member States is appropriate**.** Nowadays, managers are able to carry out activities such as payments and repurchases from remote locations without a physical presence in all Member States. The ban thus **reduces distribution costs**, which facilitates market entry in those Member States which have so far required such a presence.

Currently, national criteria for de-notification either do not exist or differ between Member States, so fund managers may not be able to establish common strategies for an orderly market exit. This lowers their incentive to start cross-border business in the first place. Although harmonising the criteria for de-notification increases legal certainty for fund managers, it will not increase the incentive to market funds in all Member States because the new de-notification

criteria are more restrictive than those currently applicable in several Member States. **In a market economy,** the decision to cease marketing activities should be left to the fund managers. Therefore, **there is no compelling reason why the law should determine the conditions under which an investment fund manager may de-notify his funds.** An obligation to inform investors about a pending de-notification is sufficient for investor protection.

By **defining "pre-marketing" activities**, which – in contrast to "marketing" – do not require cost-intensive notification of the competent authorities of home Member States, the Commission harmonises the different practices of the Member States and thus creates legal certainty. This **will not materially increase the distribution of AIFs to professional investors,** either nationally or across borders**, however, since the admissible scope of "pre-marketing" activities is very limited.** As a consequence, many activities will still be treated as "marketing", requiring cost-intensive notification.

The harmonisation of general principles on marketing communications may reduce costs by increasing legal certainty, thus lowering barriers to market entry. This holds true at least for those Member States in which the harmonised rules are not stricter than current national rules. However, although the rules may be necessary for UCITS and retail AIFs, they are not required for AIFs directed at professional investors, as the latter do not need protection.

These benefits are counteracted by **the** prospective **"systematic"** – albeit optional – **national notification requirement for marketing communications**. The added value of these cost-intensive notifications is not clear, as general principles concerning marketing communications apply in any case and sufficiently protect fund investors. Given that retail investors should look not only at the prospectuses but also at key information document before taking an investment decision, the additional notification requirement **is an unnecessary administrative burden for investment fund managers**. At the very least, the prospective fixed timeframe of ten days for the competent authorities to review the marketing communications prevents unnecessary delays to the market entry of a UCITS or retail AIFs.

Legal Assessment

Legislative Competence of the EU

The provision, that supervisory fees be proportionate to the expenditure and effort actually incurred by the supervisor, cannot be legitimately based on Article 114 TFEU (internal market) as it qualifies as "fiscal" under Article 114(2) TFEU. It therefore **falls outside the harmonisation competence of the EU.**

As to the applicability of Article 114(2) TFEU, a two-step legal test applies. Firstly, the aim of Art. 114(2) TFEU is to preserve Member States' sovereignty over their fiscal systems. Accordingly, *any* provision concerning *any* kind of compulsory exaction (fees included) is *potentially* fiscal because it is capable of affecting the tax system [CJEU in Case C-338/01 (Commission v. Council), para. 63]. A second assessment is then required to verify whether the relevant provision *actually* erodes national prerogatives in tax matters: this is only the case where it entails fiscal policy decisions, i.e. decisions concerning taxable persons, taxable transactions, the basis of imposition, rates and the exemptions. As the relevant provision determines the criterion (proportionality to expenditure and effort) for calculating supervisory fees, it encroaches upon Member States' core competence to decide upon their fiscal policy and cannot, accordingly, rely on Article 114 TFEU. The Court of Justice confirms this by stating that the very fact that a provision is qualified as "fiscal" in some Member States – as in this case [Commission Impact Assessment, SWD(2018)54, pp. 44, 85] – corroborates its qualification as a "fiscal provision" under Article 114(2) TFEU [CJEU in Case C-338/01 (Commission v. Council), para. 64].

Subsidiarity

Unproblematic, given that the regulation deals with cross-border matters.

Proportionality with respect to Member States

Unproblematic.

Compatibility with EU Law in other Respects

Unproblematic.

Impact on and compatibility with German Law

The German Capital Investment Code (Kapitalanlagegesetzbuch, KAGB) will have to be amended.

Conclusion

The proposal that managers of UCITS and retail AIFs can no longer be required to be "physically present" in host Member States reduces distribution costs. In a market economy, there is no compelling reason why the law should determine the conditions under which an investment fund manager may de-notify his funds. Defining "pre-marketing" activities will not materially increase the distribution of AIFs to professional investors, since the admissible scope of "pre-marketing" activities is very limited. The "systematic" national notification requirement for marketing communications is an unnecessary administrative burden for investment fund managers. The provision that supervisory fees be proportionate to the expenditure and effort incurred by the supervisor falls outside the harmonisation competence of the EU.