KEY EMERGING REGULATORY ISSUES AND FOCUS AREAS FOR INSTITUTIONAL ASSET MANAGERS

This publication maps out key current areas of legal or regulatory change that are of specific relevance for institutional asset managers. These focus areas are arranged thematically, by those that affect managers or management, and those that are more impactful at the fund level. While each area is unique, some common policy drivers and themes are apparent including long termism, managing systemic risk, and value for money. Some issues will require asset managers to comply with new rules or requirements. Others offer an opportunity to participate in an evolving discourse and a chance to contribute to and shape developments in a given area. In each case, senior management should keep abreast of and engage with the key policy drivers and areas of change relative to their impact on the firms they are responsible for.

There are, of course, many other more general areas of regulatory development that are also relevant to institutional asset managers. Topics such as Brexit, MAR, MiFID II, and operational resilience are all covered in Latham & Watkins' July 2019 progress report 10 Key Regulatory Focus Areas for UK/European Wholesale Markets in 2019.

MANAGERS / MANAGEMENT

Prudential / governance

Shareholder engagement and stewardship

Transparency on shareholder engagement activities and investment strategies has been at the heart of a number of pieces of consultation and reform recently. Asset managers will need to grapple with new regulatory rules that were recently implemented while keeping one eye firmly fixed on the evolving dialogue in this area — which could lead to further regulatory reform in due course.

Most immediately impactful for asset managers are the additional regulatory requirements imposed by the Second Shareholders' Rights Directive (SRD II) in relation to investments in listed companies on EEA-regulated markets or comparable non-EEA markets (the latter being an extension imposed by the FCA on top of SRD II's core requirements). SRD II's overall objective is to encourage shareholder engagement and improve transparency. Asset managers (which includes MiFID portfolio managers, AIFMs, and UCITS management companies) are required to: (a) disclose to investors how their investment strategy complies with the agreed mandate and contributes to medium-to-long-term performance (Investment Strategy Disclosure); and (b) publish a shareholder engagement policy and provide annual disclosure in relation to shareholder engagement and voting behaviour (Engagement Policy and Behaviour). The FCA rules that implemented SRD II came into force on 10 June 2019.

Each of the obligations identified above presents challenges for asset managers, and more challenges will invariably arise as the rules bed in. In relation to the Investment Strategy Disclosure, firms will need to identify to whom the disclosure should be made (disclosure is only required to be given to "institutional investors", which has a restricted definition under SRD II). In relation to the Engagement Policy and Behaviour, firms will need to ensure they have sufficient detail to provide their annual disclosure, and systems in place to identify what amounts to "significant votes" (as opposed to insignificant votes, in relation to which disclosure is not required).

Additionally, the FCA is considering broader regulatory changes on the subject of stewardship, and issued a Discussion Paper on building a regulatory framework for effective stewardship (DP19/1) at the start of 2019, in conjunction with the Financial Reporting Council (FRC). The Discussion Paper covers a number of topics, including: (a) whether more can be done to incentivise international investors to ensure they recognise the benefits of exercising stewardship, including in relation to their UK assets; (b) whether there is a case to expand stewardship beyond traditional equities; and (c) whether a greater emphasis should be placed on regulatory rules rather than codes of best practice such as the UK Stewardship Code. The FCA and FRC will publish a feedback statement later in the 2019/20 financial year. The proposals and discussion points could, in due course, bring about significant regulatory reforms.

In tandem with the Discussion Paper, this year has seen the FRC consult on changes to the UK Stewardship Code. The Code, whose obligations are significantly more demanding, is voluntary and sits on top of the regulatory baseline in SRD II. Key proposed changes include: (a) introducing a definition of stewardship; (b) setting a higher standard for asset managers regarding how they integrate stewardship responsibilities into the investment process; and (c) requiring signatories to take into account environmental, social, and governance factors. A revised Code is due later this year.

New prudential and remuneration regime for investment firms

The prudential treatment of investment firms is changing in the near term, and asset managers who take the form of or include a MiFID investment firm in their group will likely see an uptick in their capital/prudential requirements and remuneration obligations.

Since 2015, the EU has been working towards reforming the prudential regime for investment firms and making it proportionate to the risk posed by investment firms. This work is encapsulated in the Investment Firms Regulation and Investment Firms Directive, due to be published in the Official Journal shortly, with an expected FCA consultation on UK implementation later this year. There will be an 18-month implementation period and so the rules will come into force post-Brexit. However, the UK government and the FCA have signalled an intention to replicate this legislation in the UK.

Asset management groups operating across Europe typically have at least one MiFID investment firm within their group performing a combination of portfolio management, investment advice, and/or execution activities. Such firms typically are classified as either BIPRU firms or, in some cases, exempt CAD firms. In both cases, relatively light capital and remuneration standards apply.

The new rules will offer four streamlined classifications (down from the current 10). The top two classifications (referred to as “Class 1” and “Class 1 minus”) are unlikely to be relevant to asset managers, and are applicable only if a firm deals on own account or has an underwriting permission. What separates the remaining two classifications (referred to as “Class 2” and “Class 3”) and the implications therein will be of most relevance to asset managers.

Class 2 operates as the “default” classification. To qualify as a Class 3 firm, a firm cannot hold client money or safeguard/administer assets. In addition, some K-Factors (these measure the risk posed by a firm relative to the nature and volume of its activities) must be zero (including, for example, those relating to net position risk, clearing margin given, trading counterparty default, and daily trading flow). For many current BIPRU or exempt CAD firms, these requirements may well be met. However, certain other thresholds will be more problematic. Specifically, to qualify as a Class 3 firm, the firm must, in summary: (a) have less than €1.2 billion in assets under management on an individual and group basis; (b) handle client orders of less than €100 million/day for cash trades, or €1 billion/day for derivatives on an individual or group basis; (c) have total annual gross revenue of under €30 million on an individual and group basis; and (d) have an on and off balance sheet total of below €100 million.

The dividing barrier between Class 2 and 3 is granular and technical, and firms should ensure they properly engage with the criteria. Firms falling into Class 2 face a significantly heightened compliance burden compared with Class 3 firms. In summary:

- Class 2 firms will be subject to a permanent minimum capital requirement of €150,000 (provided they do not deal on own account or underwrite) with complex variable capital requirements that take into account the K-Factors (see above). For many Class 2 firms, this will mean holding significant capital in excess of their permanent minimum requirement. Class 3 firms will be subject to a permanent minimum capital requirement of €75,000 and a variable capital requirement that is the higher of their minimum requirement and one-quarter of the previous year’s fixed overheads.
- Class 2 firms will be subject to a number of other prudential requirements that may not apply to Class 3 firms. These include liquidity rules, large exposures, ICAAP, Pillar 3 public disclosures, and other regulatory reporting requirements.
- Class 3 firms will remain subject to the non-prescriptive MiFID II remuneration and governance regime. In contrast, Class 2 firms will be upgraded to more onerous requirements that resemble the requirements in some current regimes (*e.g.*, CRD IV, AIFMD, and UCITS). For high earners/material risk takers, these requirements include pay deferrals, a requirement for some pay to take the form of non-cash instruments, and malus and clawback mechanisms. However, Class 2 firms will not need to apply the bonus cap. Class 2 firms will also be required to put in place a gender-balanced remuneration committee and fulfil onerous public disclosure requirements.

Addressing liquidity mismatches

The recent fallout from the likes of Woodford, GAM, and H20 has brought liquidity issues into sharp regulatory focus. That focus looks set to remain, and the FCA at least seems keen on pursuing regulatory reform post-Brexit.

In the wake of the Woodford crisis, the FCA has been publicly critical of the UCITS rule that provides for a 10% limit on the proportion of unlisted securities held within a fund. In addressing the Treasury Select Committee on the Woodford suspension, FCA Chief Executive Andrew Bailey called the cap “flawed” and “excessively rules-based” and hinted that the rule may need to be revisited post-Brexit. Mr. Bailey’s comments were specifically aimed at what he described as “regulatory arbitrage”, which saw the listing of previously unlisted assets on the Guernsey stock exchange in an attempt to keep the Woodford fund under the 10% cap.

Liquidity is not a new issue on the FCA's radar. Last year, the FCA published a Consultation Paper on illiquid assets and open-ended funds (CP18/27) that focussed primarily on Non-UCITS Retail Schemes. This Consultation Paper followed an earlier Discussion Paper on the same topic and drew on the experience of property fund suspensions in the wake of the Brexit referendum. The FCA broadly took the view that retail investors should continue to be able to invest in illiquid assets through open-ended funds, but noted that there were specific measures that the FCA could take to clarify the use of suspensions, to strengthen liquidity management processes and improve disclosure to investors.

In a European context, ESMA recently published its final Guidelines in relation to liquidity stress tests of investment funds (both AIFs and UCITS). ESMA's Guidelines require fund managers to stress-test the assets and liabilities of the funds they manage. This includes redemption requests by investors, which are, in ESMA's view, the most common and important source of liquidity risk and could also impact financial stability. Fund managers will need to apply a comprehensive set of guidelines when designing the scenarios, policies, and frequency of liquidity stress tests for the funds they manage. The Guidelines also recommend managers notify National Competent Authorities of material risks and actions taken to address them. One Guideline also applies to depositaries, requiring verification that the fund manager has in place documented procedures for its liquidity stress-testing programme. The requirements set out in the Guidelines are supplementary to the requirements on liquidity stress testing which are enshrined in the AIFMD and UCITS Directives and are already applicable. The Guidelines are applicable from 30 September 2019.

It remains to be seen whether UK or EU regulators seek to mirror the rules adopted in the United States by the SEC in relation to liquidity buckets. Under those rules, certain mutual funds are required to classify their assets as falling into one of four buckets ranging from "highly liquid" (able to be realised within three days) to illiquid (cannot be realised within seven days without significantly impacting the market value of the investment). Impacted funds are restricted from having more than 15% of their value in illiquid funds. Feedback from market participants to date has highlighted an increased compliance burden in identifying and policing the buckets.

Conduct

Competition

Since gaining its competition law powers in 2015, the FCA has set a focus on competition within the asset management sector. The FCA launched its sweeping asset management market study in November 2015, and is still in the process of implementing various remedies. For asset managers organised as AIFMs or UCITS management companies, new rules in relation to value assessment (requiring fund managers to assess annually whether the charges taken from a fund are justified in the context of the overall value provided by the fund) and independent directors (requiring that independent directors make up at least 25% of an authorised fund manager's board, with a minimum of two independent directors) come into force shortly, on 30 September 2019. The new Prescribed Responsibility, requiring a Senior Manager to take reasonable steps to ensure that the firm complies with its obligation to carry out the assessment of value, the duty to recruit independent directors, and the duty to act in the best interests of fund investors, will apply from 9 December 2019, when the SMCR comes into force for asset management firms.

In May 2019, the FCA published the details of its first successful competition law enforcement action. The FCA found that three asset managers breached competition law by sharing information in relation to two securities offerings. The decision sets out some useful parameters as to when information sharing will likely be considered problematic, although it does not provide a clear answer to the question of what information can or cannot be shared. Asset managers should take particular note of the behaviours that the FCA identified as breaching competition law, especially if what could on the one hand be viewed as acting to secure the best price for clients or investors oversteps the mark. The FCA also used the opportunity to comment on firms' awareness of competition law risk more generally, reminding firms that they should ensure their employees know about competition law and understand that disclosing information to, and accepting it from, competitors could be illegal. Although this message holds true across the financial services sector as a whole, asset managers should be particularly mindful of competition law risk, given the FCA's focus on the sector.

Pricing of trade data

The pricing of trade data has been a key concern for asset managers for many years.

MiFID II was intended to lower the cost of market data and facilitate the provision of a consolidated tape of trade data. ESMA published a Consultation Paper in July 2019, which examined developments in both of these areas since the MiFID II regime came into effect. This consultation forms part of a scheduled review of the relevant provisions of MiFID II, mandated by the legislation.

ESMA's key finding from its initial analysis was that the price of trade data has not been reduced. ESMA noted that data users (including asset managers) and trading venues continue to disagree on whether the price for market data is reasonable. According to ESMA, data users report that prices have not decreased since MiFID II came into force, and have in some cases increased. Further, data users are finding that new fees have emerged, and that pricing models are often opaque. ESMA requested feedback from market participants on these issues, and intends to submit its final review report to the European Commission in December 2019. Asset managers should watch any developments closely, to see if ESMA's findings prompt change in this area.

Additionally, ESMA examined the reasons why no consolidated tape providers have emerged in the EU. ESMA considers that the regulatory framework is too restrictive, there is not enough of a commercial incentive, and providers would face substantial competition from non-regulated entities such as data vendors. ESMA went on to examine how different solutions, such as mandating contributions or consumption, could lead to the success of a consolidated tape provider if it is decided to move ahead with establishing such a provider in the EU. At this stage, the European Commission will most likely exercise its power to appoint a consolidated tape provider, given the potential benefits and the lack of voluntary providers. Again, asset managers will be keen to follow any developments, given the potential benefits to them of having a consolidated tape provider in the EU.

From a UK perspective, the FCA was planning to publish a Call for Input to explore the access and use of data in wholesale markets. The FCA's Business Plan for 2019/20 indicated that this would be published in Autumn 2019. However, the FCA announced on 9 September 2019 that it was postponing this work to allow firms more time to focus on Brexit planning. Asset managers should be prepared to feed in their views in due course.

New AIFMD definition of "pre-marketing"

On 12 July 2019, a new EU Directive was made into law that will, among other things, introduce a new definition of "pre-marketing" under the AIFMD. The new definition will apply from 2 August 2021. At present, there is no harmonised definition of what constitutes pre-marketing and so EU Member States take differing views as to the stage at which formal marketing notifications must be made. For this reason, funds often choose to market into jurisdictions that have a more generous approach to pre-marketing, knowing they can more easily test investor interest without needing to comply with all of the formal marketing requirements, which can be impractical to comply with at an early stage, such as when the fund is not yet formed.

The new harmonised definition will capture a broad range of activities. To avoid straying into formal marketing, firms must ensure that any pre-marketing does not amount to an offer or placement and that investors are not able to subscribe for an interest in the fund. However, firms may circulate draft offering documents, provided that they include certain disclaimers. Managers engaging in pre-marketing will be required to notify the relevant regulator within two weeks of beginning pre-marketing. Further, a subscription by a professional investor within an 18-month period of pre-marketing having begun will automatically be considered to be the result of marketing, which is likely to have an impact on current market practice in relation to reverse solicitation, as it will narrow the instances in which reverse solicitation may be relied upon.

Although the Directive will not apply the new definition of pre-marketing to non-EU managers, Member States are not permitted to treat third-country firms more favourably than EU firms. Hence, Member States will likely incorporate the change into their national private placement regimes. This will be important for UK-based managers, in the context of Brexit. It remains to be seen whether the UK will implement the changes in UK law post-Brexit, or whether the UK will continue with its more generous approach to pre-marketing (as the operative provisions of the Directive are not yet in force, they will not be onshored on exit day).

Although this change is still some way off, it is likely to have a significant impact on market practices, and so AIFMs should consider how it will affect their approach to marketing.

FUND LEVEL

Sustainable finance

Until relatively recently, sustainable investing was almost exclusively a matter of investor or asset manager preference. However, as legal frameworks begin to change to support the transition to a low carbon economy — both in the UK and internationally — this transition, as well as the effects of climate change, may have a major impact on financial markets and products in the near to medium term.

In early July, the UK government published its policy paper on the Green Finance Strategy — a strategy that "recognises the role of the financial sector in delivering global and domestic climate and environmental objectives". The Green Finance Strategy has three strategic pillars:

- "Greening finance" aims to ensure that the opportunities and risks arising vis-a-vis climate and environmental factors are integrated into financial decision-making and that the green product market is robust.
- "Financing green" refers to the plan to encourage flows of private finance into key clean growth and environmental sectors.
- "Capturing the opportunity" seeks to ensure that the UK takes advantage of the commercial opportunities arising from green finance and builds on its experience in this area.

Consistent with the above, regulators are increasingly acknowledging that it is within their remit to identify, explore, and promote sustainable finance and climate change issues more broadly. In a joint statement released in conjunction with the Green Finance Strategy, the PRA, FCA, FRC, and The Pensions Regulator each acknowledged the role they had to play in "one of the defining issues of our time".

The Green Finance Strategy does not include any mandatory requirements for business, but does include the government's expectation that all listed companies and large asset owners disclose climate risk by 2022. This suggestion reflects recommendations published by the Task Force on Climate-related Financial Disclosures (TCFD) in a final report from 2017. The TCFD was charged with developing a voluntary framework for disclosure of material climate change financial impacts. This is not the first time the TCFD's recommendation has been explored.

In its Discussion Paper on Climate Change and Green Finance released in October last year, the FCA asked for views on such a reporting regime for financial services firms. In particular, the FCA identified that disclosures should reflect the risk in the financial sector in which a firm operates. For instance, a report prepared by an asset manager would set out how it managed the risk to long-term investments. The government intends to establish a joint taskforce with UK regulators to examine the most effective way to approach climate-related disclosure.

European authorities have been equally focused on sustainable finance. In March 2018 the European Commission published its Action Plan on financing sustainable growth. The Action Plan aims to re-orientate investment to sustainable technologies and business, finance growth in a sustainable way, and help to create a low-carbon, climate resilient economy. The Commission subsequently adopted a package of measures that implemented several actions contained in the Action Plan including:

- A proposal for a regulation on the establishment of a framework to facilitate sustainable investment. This regulation establishes the conditions and the framework to gradually create a unified classification system (or taxonomy) as to what can be considered an environmentally sustainable economic activity.
- The Commission believes this is a first and essential step in the efforts to channel investments into sustainable activities.
- A proposal for disclosures relating to sustainable investments and sustainability risks that integrate the TCFD recommendations.
- In addition to the above, the Commission has emphasised that it intends to clarify how asset managers integrate sustainability risks and, if relevant, other sustainability factors in the areas of organisational requirements, operating conditions, risk management, and target market assessment.

Margin rules for uncleared derivatives

The BCBS and IOSCO announced on 23 July 2019 that they are recommending extending the final phase-in of initial margin (IM) requirements by one year. Implementation would be split, such that entities with an aggregate average notional amount (AANA) of non-centrally cleared derivatives between €50 billion and €750 billion would still have to comply with the 1 September 2020 deadline, but entities with AANA between €8 billion and €50 billion would not have to comply until 1 September 2021.

This announcement will come as a relief for many in the asset management sector who are grappling with how to prepare themselves for the exchange of collateral under EMIR, particularly smaller firms that will fall within the new category with a later implementation date. Implementation of the IM requirements is a particular challenge for buy-side firms, which will need to implement various new arrangements in order to comply with the requirements, from legal documentation to new IT systems. This is a much more challenging regulatory change project than, for example, the implementation of the variation margin requirements. In particular, segregation of assets, as well as liquidity and funding issues, are all likely to prove difficult for buy-side firms.

It should be noted that the recommendation is not binding, and would require amendments to EMIR in order to take effect in the EU (and to onshored EMIR, in a post-Brexit UK). While it seems likely that the EU will follow the recommendation, asset managers must wait for the EU to confirm its intentions. However, even with the delay, smaller firms will not have time to relegate implementation to the bottom of their priority lists. Given the legal and operational uplift likely to be required to comply with the IM requirements, smaller asset managers will need to use the extra time to ensure they are fully prepared.

Non-performing loans

Credit focussed asset managers should keep a watching brief on the proposed Directive on credit servicers, credit purchasers, and the recovery of collateral.

While the proposed Directive is not due to be implemented imminently, asset managers should keenly observe developments in relation to the provisions applicable to credit purchasers. At present, the draft text of the Directive includes various obligations in relation to the purchase of non-performing loans by non-bank entities (such as asset managers) and creates new and potentially onerous procedural and information requirements. Such proposals are somewhat at odds with the current market, where *caveat emptor* rules. The proposals may have unintended consequences with respect to timing and market liquidity.

Benchmark transitions

The transition away from LIBOR has been described by many as a larger operational challenge than Brexit, and the regulators have been keen to stress how important it is for firms to be actively implementing their transition plans. Asset managers face various exposures to LIBOR, whether it be through LIBOR-based products in their portfolios, using LIBOR as a benchmark for the performance of their funds, or within other operational areas such as the firm having loans with LIBOR-based interest rates.

In June 2019, the FCA and the PRA published feedback from the responses they received to their September 2018 Dear CEO letter on firms' preparedness for LIBOR transition. Although not specific to the asset management sector, this feedback contains some useful considerations. It emphasises that exposures to LIBOR can be found in an array of areas within a firm's business, and that firms should undertake a comprehensive assessment of their exposures. This assessment should also include identification of any associated prudential and conduct risks (e.g., could information asymmetries in the market give rise to market abuse concerns). The regulators also highlighted that, while firms should be keeping pace with industry initiatives, they must not let a "wait and see" attitude inhibit their transition plans. These are all important concerns that asset managers should factor into their planning.

Away from LIBOR, asset managers must be mindful as to whether other benchmarks they currently rely upon to determine asset allocation or to track performance of a fund will continue to be available for use from 1 January 2020 as a result of the end of the transitional period under the EU Benchmarks Regulation. Consideration should also be given to the impact on any derivative transactions entered into by buy-side institutions with their sell-side counterparts that rely on indices within scope of the Regulation to ensure that sell-side counterparties have appropriate fall-back arrangements in place for those trades. This relates to both industry benchmarks (e.g., those traditionally provided by the Investment Association and Association of British Insurers) and bespoke benchmarks administered by market counterparties and third-party index providers. The key timing triggers are as follows:

		NO BREXIT	NO-DEAL BREXIT
	UK funds/transactions linked to UK administered indices [1]	Cease use on or before **31 December 2019** [2] unless administrator authorised/registered in an EU Member State (or has at least applied for authorisation/registration)	Cease use on or before **31 December 2019** [2] unless administrator authorised/registered by the FCA (or has at least applied for authorisation/registration)
	UK funds/transactions linked to EU administered indices [1]	As above	Cease use on or before **31 December 2022** unless administrator authorised/registered by the FCA
	UK funds/transactions linked to third-country (non-EU) administered indices	Cease use on or before **31 December 2021** [2] unless administrator included on ESMA register	As above
	EU funds/transactions linked to UK administered indices [1]	Cease use on or before **31 December 2019** unless administrator authorised/registered in an EU Member State (or has at least applied for authorisation/registration)	Cease use on or before **31 December 2021** unless administrator included on ESMA register
	EU funds/transactions linked to EU administered indices [1]	As above	Cease use on or before **31 December 2019** unless administrator authorised/registered in an EU Member State (or has at least applied for authorisation/registration)
	EU funds/transactions linked to third-country (non-EU) administered indices	Cease use on or before **31 December 2021** unless administrator included on ESMA register	Cease use on or before **31 December 2021** unless administrator included on ESMA register

[1] Assumes those indices were launched before 1 January 2018 if the administrator began providing benchmarks on or after 1 July 2016. If launched subsequent to that date by an administrator that only began providing benchmarks on or after 1 July 2016, the relevant UK/EU administrator should already have obtained authorisation.
[2] This extended transitional date has not yet been made into law, but has been agreed by the EU legislators.

Contacts

David Berman
Partner
T +44.20.7710.3080
E david.berman@lw.com

Carl Fernandes
Partner
T +44.20.7710.4777
E carl.fernandes@lw.com

Nicola Higgs
Partner
T +44.20.7710.1154
E nicola.higgs@lw.com

Rob Moulton
Partner
T +44.20.7710.4523
E rob.moulton@lw.com

Charlotte Collins
Knowledge Management Lawyer
T +44.20.7710.1804
E charlotte.collins@lw.com

Kishore Bhindi
Associate
T +44.20.7710.4785
E kishore.bhindi@lw.com

Sherryn Buehlmann
Associate
T +44.20.7710.3043
E sherryn.buehlmann@lw.com

Brett Carr
Associate
T +44.20.7710.4695
E brett.carr@lw.com

Becky Critchley
Associate
T +44.20.7710.4519
E becky.critchley@lw.com

Stuart Davis
Associate
T +44.20.7710.1821
E stuart.davis@lw.com

Gabriel Lakeman
Associate
T +44.20.7710.4645
E gabriel.lakeman@lw.com

Anne Mainwaring
Associate
T +44.20.7710.1018
E anne.mainwaring@lw.com

Sam Maxson
Associate
T +44.20.7710.1823
E sam.maxson@lw.com

Denisa Odendaal
Associate
T +44.20.7710.1845
E denisa.odendaal@lw.com

Jonathan Ritson-Candler
Associate
T +44.20.7710.1815
E jonathan.ritson-candler@lw.com

Katy Sanders
Associate
T +44.20.7710.4548
E katy.sanders@lw.com

Sean Wells
Associate
T +44.20.7710.4662
E sean.wells@lw.com