"Onshoring" Statutory Instruments Comment Series: Investment Funds and their Managers

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Financial Markets Law Committee[1]

This paper has been prepared by the FMLC Secretariat.[2]

[1] In view of the role of the Bank of England, the Financial Conduct Authority and HM Treasury in the U.K.'s preparations for withdrawal from the E.U., Sinead Meany, Sean Martin and Peter King took no part in the preparation of this paper and the views expressed should not be taken to be those of the Bank of England, the FCA and HM Treasury.

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1. EXECUTIVE SUMMARY AND INTRODUCTION

1.1. The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. In June 2016, the U.K. voted by way of an in/out referendum to withdraw from the European Union (known colloquially and in this paper as "**Brexit**"). On 29 March 2017, HM Government took the first step in the withdrawal process and officially served notice to the E.U. of the U.K.'s withdrawal under Section 50 of the Treaty on European Union ("**TEU**"), beginning a two-year "notice" and negotiation period, and setting the date on which the U.K. will withdraw from the E.U. ("**exit day**") as 29 March 2019.[3] A post-Brexit longer-term relationship is, as yet, largely undecided and, therefore, preparations on the domestic front have focused on a "no deal" eventuality.[4]

1.3. A key element in HM Government's plan to ensure continuity in law during and after Brexit in the U.K. is the European Union (Withdrawal) Act 2018 (the "**Withdrawal Act**") which aims, *inter alia*, to incorporate into U.K. law all applicable E.U. legislation and to give powers to Ministers to make amendments to such retained law as are necessary to deal with any deficiencies arising from withdrawal.[5] In furtherance of these aims, HM Treasury has begun to publish drafts of statutory instruments ("**SIs**") which will "onshore" E.U. legislation related to the financial markets.[6]

1.4. This paper considers legal uncertainties arising from the changes proposed by two draft SIs key to investment funds and their managers—the Draft Alternative Investment Fund

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3 Legislative provisions defining exit day as 29 March 2019 can be found in the European Union (Withdrawal) Act 2018. Section 20(4) of that Act gives a Minister of the Crown the power to amend the definition of exit day so that it correctly refers to the day on which the E.U. Treaties cease to apply to the U.K.

4 U.K. and E.U. negotiators have drafted a treaty which will govern the future relationship. The post-Brexit deal offers, *inter alia*, a 21-month transitional or "implementation" period during which the U.K. will continue to participate in the single market and customs union. On 25 November 2018, E.U. Member States approved the treaty. A vote on the deal has been scheduled in the U.K.'s House of Commons for 12 December 2018. See: Barker A and Khan M, "Sombre E.U. bids farewell and signs off Brexit deal", *Financial Times*, (25 November 2018), available at: https://www.ft.com/content/5f1dba3c-f0cf-11e8-ae55-df4bf40f9d0d.

5 Text of the European Union (Withdrawal) Act 2018 is available at: http://www.legislation.gov.uk/ukpga/2018/16/pdfs/ukpga_20180016_en.pdf.

6 A list of the statutory instruments published in relation to the financial services, included those which have been put before Parliament for approval, can be found on the following webpage: HM Government, *Financial services legislation under the EU (Withdrawal) Act 2018,* (first published 9 August 2018), available at: https://www.gov.uk/government/collections/financial-services-legislation-under-the-eu-withdrawal-act?utm_source=ed3e24c1-615b-4397-a940-f10eb4c57fcd&utm_medium=email&utm_campaign=govuk-notifications&utm_content=immediate.

Managers (Amendment) (EU Exit) Regulations 2018 (the "**draft AIFM SI**") and the Draft Collective Investment Schemes (Amendment etc.) (EU Exit) Regulations 2018 (the "**draft CIS SI**") (collectively the "**draft investment fund SIs**"). As with all the SIs published in pursuit of the aims of the Withdrawal Act, the FMLC understands that the draft investment fund SIs will be laid before Parliament with the intention of implementing a policy position arising from a "no deal" Brexit. The Committee does not comment on matters of policy or the form that future regulatory approaches, if any, should take and this report should not be understood to constitute comments thereon. Nevertheless, the Committee has drawn attention to some legal and operational uncertainties which will arise in a "no deal" context in which it is anticipated the draft investment fund SIs will be implemented.

2. LEGAL UNCERTAINTIES AND IMPACT

References to other legislation

2.1. As the legislation amended by the draft investment fund SIs contains cross-references to definitions, standards and rules from other relevant pieces of directly applicable, domestically implemented (pre-Brexit) or retained (post-Brexit) E.U. law, the SIs caveat such references by inserting into the amended law provisions to snapshot the referenced law or rules. The FMLC notes, generally, that these provisions freeze the law at two points in the future so as to allow market participants to plan for a post-Brexit, "no deal" future. In the Alternative Investment Fund Managers Regulations 2013 (the "**AIFM Regulations 2013**"), the draft AIFM SI requires that references to domestic law or E.U. regulations, decisions or tertiary legislation are to be read as references to the law *as it has effect on the day on which the Alternative Investment Fund Managers (Amendment) (EU Exit) Regulations 2018 are made*" whereas references to sourcebooks published by the U.K.'s Financial Conduct Authority ("**FCA**") are to be taken as references to rules made and guidance issued by the FCA *as it has effect on exit day*.[7] The draft CIS SI makes

[7] Regulation 3(4) of the AIFM SI inserts at the end of Regulation 2 of the AIFM Regulations 2013:

> "(5) Any reference in these Regulations to a sourcebook is to a sourcebook in the Handbook of Rules and Guidance published by the FCA containing rules made and guidance issued by the FCA under the Financial Services and Markets Act 2000 *as it has effect on exit day*.
>
> (6) Any reference in these Regulations to any EU Regulation, EU decision or EU tertiary legislation (within the meaning of Section 20 of the European Union (Withdrawal) Act 2018(d)) is, unless the contrary intention appears, to be treated as a reference to that EU regulation, EU decision or EU tertiary legislation *as it has effect on the day on which the Alternative Investment Fund Managers (Amendment) (EU Exit) Regulations 2018 are made*."

a similar provision requiring references to any FCA sourcebooks to be read as references as of exit day.[8]

2.2. While the FMLC understands the practical need to have a snapshot of E.U. law as of the date on which the AIFM SI is made—that is, because certain provisions of the AIFM SI come into force not on exit day but on the day after the SI is made—this does give rise to two potential areas of complexity. First, the Committee is unsure about how the SI as currently drafted, with references to E.U. legislation "as of the date on which these Regulations are made", will take into account any changes in E.U. law—including, for example, *via* opinions of the European Court of Justice—in the *interregnum* before exit day. Second, and similarly, the Committee observes that the SI would have to be adapted were the proposed 21-month implementation period to be agreed, during which the U.K. will continue to receive E.U. law which comes into effect. In that case, the cross-references in the SI to other E.U. legislation which were cut-off by exit day will presumably be amended to refer to a cut-off date which is the date at which the implementation period ends. A similar exercise would be needed for references to the day on which the draft SI is enacted, which gives rise to concerns that the existence of two snapshots will complicate the continued reception of E.U. law.

2.3. There is, of course, the related question of how the law will evolve as and when the FCA updates relevant sections of the Handbook—the FMLC notes that, in order for the law to refer to the correct version of the FCA Handbook, a new SI might be necessary to correct the references. Such additional steps—and the potential for a gap in the time between the amendment to the FCA Handbook and the relevant legislation being updated—carry potential legal and operational uncertainty. The FMLC would recommend that HM Treasury and/or the FCA clarify how subsequent updates to guidelines and rules will be reflected in the legislation.

Temporary Marketing Provisions for funds

2.4. Regulation 14(2) of the draft AIFM SI inserts into the AIFM Regulations 2013 new Regulations 78A to 78E providing for a temporary permission granted to "a relevant fund" which was, or could have been, marketed in the United Kingdom before exit day, or to an alternative investment fund manager ("**AIFM**") which is authorised in its Home Member State in accordance with Article 6.1 of Directive 2011/61/EU on Alternative Investment Fund Managers (the "**Alternative Investment Fund Managers**

[8] Regulation 34(4) of the draft CIS SI.

Directive" or the "**AIFMD**") to continue to market a U.K. alternative investment fund ("**AIF**") in the U.K. on the basis of the same terms and conditions.[9] Regulation 78B(1) and (2) provide that an E.E.A. AIFM is to be treated as if it is an authorised person if it satisfies certain conditions including if immediately before exit day it "was marketing" an E.E.A. AIF, U.K. AIF or Third Country AIF in the U.K. in reliance respectively on its rights under Articles 32 and 36 of the AIFMD. It is uncertain whether it would be necessary for an E.E.A. AIFM to be actively marketing a relevant AIF before exit day in order to benefit from such deemed authorisation, such that it would not be sufficient for it to be "entitled to market" the AIF (the concept used in new Regulation 78A(2)) or if it "could have" marketed the AIF (the concept used in Regulation 78A(1)(a)). Clarification on the conditions which AIFs or AIFMs must meet to continue to be able to market in the U.K. would be helpful to those market participants planning for Brexit.

2.5. Similarly, new Regulation 78C(1)(a) provides that the temporary permissions period ends "after three years beginning with the day on which exit day occurs". This seems open to interpretation. If exit day is 29 March 2019 at 11pm, then the last day of the relevant period could be interpreted as 28 March 2022, 29 March 2022 or 30 March 2022. Further, since the period ends "after three years", it could be read as any time after that date. The uncertainty could be ameliorated by amending the provision to read "on the third anniversary of exit day".[10]

2.6. The FMLC notes that, in line with HM Government's stated policy intention with regards to transitional relief, the temporary marketing provisions in the AIFM SI are only available to incoming E.E.A. AIFMs. There are, therefore, no provisions within new Regulations 78A to 78E in relation to full-scope UK AIFMs. Practical question might arise, however, for such full-scope U.K. AIFMs which are currently marketing E.E.A. AIFs in the U.K. Such AIFMs will have, pre-exit day, applied for FCA approval to market under Regulation 54 of the AIFM Regulations 2013 to market any AIF managed by the AIFM that does not fall within Regulations 57(1) (which covers marketing of third country AIFs under Article 36 AIFMD). On exit day, by definition, the E.E.A. AIF will become a Third Country AIF. Simply on the basis of these provisions, it appears that the previous Regulation 54 will no longer be effective and the U.K. AIFM will have to reapply for permission to market that AIF under the revised Regulation 57 of the AIFM Regulations 2013—i.e., under national private placement. It seems unclear why U.K. AIFMs, which have already obtained approval from the

[9] Provided for by new Regulation 78A

[10] The FMLC understands that this point cannot be explained by the Interpretation Act 1978.

FCA to market E.E.A. AIFs should be required to go through the steps of making a separate (and largely duplicative) notification. It is also unclear as to how and when the U.K. AIFM would be required to make such a re-notification, since there are no provisions in the draft AIFM SI which might suggest that the U.K. AIFM could make notifications in advance of exit day (by definition, E.E.A. AIFs will not be Third Country AIFs until exit day; technically, a Regulation 57 notification cannot be made until they are classed as Third Country AIFs). It would be helpful if the approvals given to U.K. AIFs under Regulation 54 before exit day were grandfathered by the draft AIFM SI or if the FCA were provided with an express power to waive the requirement for a re-notification as regards such previously-approved marketing. In the absence of such a statutory provision, it would be helpful if HM Treasury and/or the FCA could issue a statement or guidelines as to the timing of such re-application requirements for U.K. AIFMs.

2.7. A related point arises from new Regulation 78B of the AIFM Regulations which provides that an E.E.A. AIFM is to be treated as if it is an authorised person if it satisfies certain conditions.[11] It is unclear from these provisions whether this means that such an AIFM must comply with the FCA rules generally (presumably in addition to the rules of its home state competent authority), whether any FCA rules need to be modified and/or amended as they would otherwise apply to an authorised person, and further whether the authorisation extends only to the marketing activity of an E.E.A. AIFM or whether its authorisation extends more broadly to other activities. Another related uncertainty is whether the temporary marketing permission conferred on an E.E.A. AIFM extends to an AIF in respect of which the E.E.A. AIFM has itself done all that is required but the FCA has not received a regulator's notice pursuant to Regulation 49 of the AIFM Regulations.

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[11] New Regulation 78B(2) provides:

(2) An EEA AIFM satisfies the conditions in this paragraph if—

(a) immediately before exit day the EEA AIFM—

(i) was marketing—

(aa) an EEA AIF or a UK AIF in the United Kingdom in reliance on its rights under Article 32 of the directive, or

(bb) a third country AIF in the United Kingdom in reliance on its rights under Article 36 of the directive; and

(ii) was authorised to carry on a regulated activity in the United Kingdom by virtue of Section 31(1)(b) or (c) (but not Section 31(1)(a)) of the Act;

(b) after exit day, it is permitted to market that EEA AIF under regulation 78A.

Temporary recognition of UCITS

2.8. Regulation 60 of the draft CIS SI provides for similar temporary recognition of E.E.A. undertakings for collective investment in transferable securities ("**UCITS**"), subject to the fulfilment of the following conditions which are set out in Regulation 61 of the draft CIS SI: (a) immediately before exit day the collective investment scheme is an E.E.A. UCITS which is a recognised scheme by virtue of Section 264(d) of the Financial Services and Markets Act 2000 ("**FSMA**");[12] and (b) the operator of the E.E.A. UCITS has before exit day notified the FCA that it wishes the scheme to be treated in accordance with Regulation 60. Such notification and subsequent permission from the FCA, the FMLC understands, will enable the E.E.A. UCITS to continue to be marketed in the U.K. under the same terms and conditions as before exit day. In the absence of such a temporary recognition regime—or, indeed, at the end of the regime—it appears that the operator of the E.E.A. UCITS, should it wish that the UCITS continues to be recognised in the U.K. for the purpose of being marketed to retail investors, will have to apply under Section 272 of FSMA (*Individually recognised overseas schemes*) for the UCITS to become a recognised collective investment scheme. To the extent that it wishes to market the fund as an AIF (instead), it would have to apply for permission to market under Regulation 54 of the AIFM Regulations 2013 (if the operator is a U.K. AIFM) or under Regulations 58 or 59 of the AIFM Regulations 2013 (if the operator is an AIFM registered in a Third Country—which, upon exit day, will include the E.E.A.).

2.9. If an investment manager of an E.E.A. UCITS were to apply for recognition under Section 272 of FSMA at the end of the temporary recognition period, it is unclear whether such an investment manager would also be considered to be managing an AIF such that it may be required to vary its FCA permission. From Regulations 54 and the insertion of new paragraph 4A to Regulation 59 of the AIFM Regulations 2013, it is possible to infer that an investment manager and the investment scheme might satisfy both sets of requirements but, as a side note, this question may raise further uncertainties, the implications of which are as yet unclear: first, about regulatory overlap, given that, under the existing E.U. schema, these categories are regarded as mutually exclusive; and, second, about how an E.E.A. UCITS which has been marketed as such in the U.K. before exit day may fall under the amended "geographical" definitions of AIF (U.K. AIF, E.E.A. AIF or Third Country AIF) in the AIFM Regulations 2013 (given that it will not have been marketed as an AIF prior to exit day and, therefore, cannot be an E.E.A. AIF).

[12] Section 264 of the FSMA provides for the recognition of collective investment schemes constituted in an E.E.A. state.

2.10. Another question which arises in relation to the status of and requirements imposed upon E.E.A. UCITS under the temporary permission regime concerns the requirements in Regulation (EU) No 1286/2014 on key information documents for packaged retail and insurance-based investment products (the "**PRIIPs Regulation**"). Currently, UCITS are exempted from preparing a Key Information Document ("**KID**") under the PRIIPs Regulation until 31 December 2019. The FMLC would like to query whether this exemption will end on that date, as planned, for all UCITS or whether UCITS which have been granted temporary recognition may continue to be exempt until they have been granted recognition under Section 272 of FSMA. A statement from the FCA which lays out the ways in which these regimes will function consecutively—and not in coincidence—will help ensure legal certainty.

Delegation of AIFM functions

2.11. Regulation 31 of the draft AIFM SI amends provisions in relation to the delegation of AIFM functions as required by Section 8 of Commission Delegated Regulation (EU) No 231/2013 supplementing Directive 2011/61/EU with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (the "**Commission Delegated Regulation**"). The adaptation of conditions for delegation, however, does not make clear whether existing delegation arrangements which are in place as of exit day will be grandfathered or whether these will have to be reappraised. Further, in relation to such existing arrangements, it would be helpful to introduce grandfathering provisions to avoid the uncertainty that will arise in the event that the necessary cooperation arrangements required by Article 78 of the Commission Delegated Regulation as amended by Regulation 31 of the AIFM Regulations are not in place at exit day. These cooperation arrangements are essential for portfolio and risk management.

Restriction on promotion of sub-funds

2.12. Regulation 65 of the draft CIS SI provides that, should the property of a collective investment scheme which is a recognised scheme under the temporary recognition regime, be divided into sub-funds such sub-funds will be regarded as constituting AIFs and will need to be separately recognised under Section 272 of FSMA if it is intended that they are to be generally marketed in the U.K. Such a separation in categorisation and the conditions for recognition gives rise to questions related to those raised in paragraph 2.9 above about whether an E.E.A. UCITS which benefits from the temporary recognition regime will need to produce a UCITS KID, whilst a PRIIPs KID will need to be produced for the new sub-fund.

Transfer of functions

2.13. Finally, Regulation 12 of the draft AIFM SI inserts Article 69A into the AIFM Regulations 2013, bestowing upon HM Treasury the ability to make subsequent SI so as to discharge its new functions which are set out in Part 1 of Schedule A1 to the AIFM Regulations 2013. These functions range from the specification of registration obligations for small AIFMs to allow effective monitoring of systemic risk to the specification of administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms which AIFMs are required to have. Market participants have highlighted to the Committee the possibility that new SIs might be too cumbersome a mechanism, in light of the pace at which new market practices and products emerge.

3. RECOMMENDATIONS AND CONCLUSION

3.1. In this paper, the FMLC has highlighted legal uncertainties arising from the draft statutory instruments which will onshore regulations relating to investment funds and their managers. These have included uncertainties related to: (1) references to other legislation; (2) the new regimes for temporary recognition of funds and collective investment schemes; (3) arrangements for delegation by AIFMs; (4) the restriction on promotion of sub-funds; and (5) the transfer of functions to HM Treasury. In view of the substantial work which has evidently gone into drafting the SIs, the FMLC is certain that HM Treasury has already taken into account both the drafting and policy issues highlighted above. The FMLC would, nevertheless, encourage HM Treasury and HM Government to publish, wherever possible, guidance which might enable impacted funds and managers to begin planning for the future.

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[13] Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.