In focus

Regulatory landscape for asset managers in the European Union
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The current landscape for asset managers in Europe is quite distinctive. The markets are at the tail end of a long period of quantitative easing. There are signs indicating a possible global economic downturn amidst political uncertainty and trade tensions. And there now is a new European Commission that will be setting setting the regulatory and policy agenda for the years to come. In this context and as we are approaching the end of 2019, we take stock of the main themes in asset management regulation in Europe and we outline specific changes that we believe are significant for our clients and the way in which we deliver for them.

Introduction

The regulatory and policy agenda for asset management in the European Union (EU) has been significantly shaped by the Global Financial Crisis in 2008. Since then, there has been a plethora of regulatory changes that started with tightening controls and a closer look at culture in the banking sector, in light of its pivotal role in the financial system, and then the insurance sector. The asset management industry followed and has been subject to a wave of new requirements on how it runs its business, how it remunerates itself and what it discloses to its clients.

At the same time, with the Capital Markets Union agenda, policymakers have been taking further measures to ensure European capital markets are a viable, efficient and desirable financing source, particularly in the traditionally bank-based economies in continental Europe.

Much of what was decided by legislators in the past couple of years is only now being implemented by the financial industry and markets, as policymakers recognised that some lead time for implementation is needed and certain EU legislation requires either transposition in Member States or further technical detailing by supervisory authorities before full application is possible.

Right now, headlines are dominated by Brexit. For an industry that already has extensive cross-border activity, policymakers in the EU have several aspects to consider, such as continuity of business, whether there could be any disruption for clients, or whether there may be implications for financial stability. The early signs point towards more stringent oversight of third-country firms by EU regulators and an intention to take a closer look at passporting agreements.

There is a further source of geopolitical risk in the trade tensions between the US and China – and now increasingly Europe – contributing to considerable market volatility and increased prices for both households and supply chains. As the regulatory framework is adjusting, EU policymakers need to consider the EU's position in the world and particularly how it is positioned between the US and China. The debate around competition policy and the existence of 'European champions' will, in all probability, continue.

Another area of extensive debate is the role of the financial sector in supporting environmental sustainability, in light of widespread recognition of climate change and its consequences. These relate to the actual financial impact on some assets and, at the same time, higher demand from clients to combine investment with doing good for the environment (and also society).

Similarly, there is increasing awareness of the transformative effects of technology that can lend itself to more effective operations, digital distribution of products, analytics of product data, and better communication with clients. But as with every innovation, it involves new risks in areas such as cybersecurity, financial crime and client data privacy. EU regulators and policymakers are turning their attention to these areas, focusing on investor protection and market integrity as well as on the opportunities and challenges that arise for regulatory compliance and supervision.

1 K. Wade, How trade wars are rocking the wobbly world economy, Schroders, September 2019
2 For an analysis of how this has evolved in the US, see S. Markowicz, The rise of US superstar firms and its implications for investors, Schroders, November 2019

This paper reflects regulatory status and developments as of date of publication.
In light of these broader trends, financial stability and investor protection will remain significant long-term drivers of the regulatory agenda, complemented by sustainable finance, competitiveness and long-term saving. This expectation is confirmed by recent statements from the new Commission that has now been formed following the European Parliament elections in May 2019. It is worth noting that in the run-up to the elections there was heightened activity with a number of significant pieces of regulation being pushed through in spring 2019. Importantly, the elections have brought about a non-negligible change in the composition of the European Parliament generally, and more specifically in the Economic and Monetary Affairs Committee that oversees financial services.

Taking all this into consideration, we identify five key themes in both existing and forthcoming regulation: investor protection, conduct, sustainable investment, capital markets and financial stability (see Figure 1).

These five themes have been long-standing even as regulation adapts to new practices and economic realities driven by market, technological, environmental and geopolitical changes. This constancy does not signify lack of progress or imagination but rather reflects the fact that the principles and regulatory objectives remain consistent.

The following five sections explore each regulatory theme separately and list relevant regulatory developments. Since we have taken a thematic approach, some significant pieces of regulation, such as the Markets in Financial Instruments Directive II (MiFID II), are referred to more than once where they relate to multiple themes or to multiple aspects within the same theme. Where this happens, it is indicative of not only the regulatory ambition but also the complexity of the markets in which asset managers operate.

Additionally, this paper contains three appendices:

- Appendix 1 outlines some regulatory developments that are specific to the UK but that we see as relevant, particularly in the context of a possible way forward across the EU
- Appendix 2 lists a number of regulatory developments in the US where we see parallels to the regulatory focus in the EU
- Appendix 3 provides a glossary and some explanatory notes to help the reader navigate the inordinate amount of regulatory acronyms

Figure 1: Ongoing regulatory themes

1. **Investor protection**
   How do asset managers deliver for clients?

2. **Conduct**
   How do asset managers behave as firms?

3. **Sustainable investment**
   How do asset managers integrate sustainability in investment?

4. **Capital markets**
   How do asset managers transact?

5. **Financial stability**
   How do asset managers contribute to financial stability?

Source: Schroders.
Section 1: Investor protection

Consumer protection is one of the main priorities for regulators not just in Europe but worldwide. One significant challenge for the protection of investors (consumers of asset management services) is a persistently low level of financial education and literacy. A further challenge is the lack of familiarity with investment products, particularly for retail investors, compared to other savings vehicles such as bank accounts.

In this context, policymakers and regulators focus primarily on two things. First, they look into ways in which the supply side (asset managers) can provide all the means necessary for the demand side (investors) to make a decision. This invariably involves transparency on a very broad range of information. The extent to which investors engage with this information and understand it is an important question but outside the scope of this paper. Second, they look into practices such as how products are marketed, how charges are levied and how performance benchmarks are set, in order to ensure that these do not in any way result in poor outcomes for investors.

Although investor protection is about both retail and institutional investors, the regulatory focus is more often than not on the former as the non-professional, more vulnerable investor. The overarching objective within this theme is to ensure asset management services offer value for money, meet clients’ expectations and fulfil their respective financing needs.

Figure 2: Focal areas for investor protection

Cost disclosure

MiFID II has transformed transparency of costs and charges in multiple ways. It introduced requirements to disclose:

- one aggregate cost figure for the product itself, advice and distribution; transaction costs, both explicit and implicit; and the ex ante as well as ex post costs. Notably, as these rules apply on a distributor level, fund managers are not bound directly. However, they do need to make the necessary product cost information available to distributors so that they can then fulfil their obligations.

The next step in this area is to look across different cost disclosure regimes, e.g. MiFID II compared to packaged retail investment and insurance-based products (PRIIPs – see below), in order to examine consistency but also to revisit the question of whether this disclosure is effective and whether investors use it. The European Commission is likely to carry out this work in 2020.

Product governance

Another important change for investor protection is the MiFID II product governance requirements. These compel MiFID product manufacturers to identify a broad target market and take reasonable steps to ensure that their products are distributed accordingly. Furthermore, distributors are obliged to ensure that the products they offer are compatible with the target market identified by the manufacturer as part of the service they provide to the end investor. The requirements also include setting up a product approval process and reviewing the target market and the performance of their products on a regular basis.

The European Securities and Markets Authority (ESMA) has provided guidelines outlining which criteria need to be analysed to identify a target market. Among others, these include the type of clients that are targeted (retail or professional), their objectives and risk tolerance (‘suitability’) and whether they have the necessary experience and knowledge to invest in a product (‘appropriateness’).

Inducements and payment for research

The MiFID II inducement rules are quite complex but roughly they restrict the payment or receipt of all fees, commissions and non-monetary benefits (referred to as ‘inducements’) unless these enhance the quality of the service provided to a client and do not impair an EU investment firm’s duty to act in the best interests of its clients. EU investment firms are obliged to disclose to each client all fees, commissions and non-monetary benefits received in connection with any investment service provided by them to that client.

These rules had a significant impact on arrangements for the receipt and payment of broker research. Before MiFID II, research was bundled with broker commission that was paid by the fund. MiFID II determined that the provision of research would be regarded as an inducement unless it is paid for by the firm out of its own resources or from a separate ‘research payment account’ subject to specific conditions. The effect has been for asset managers to pay out of their own resources resulting in a reduction of broker research.

Concerns have been voiced around challenges for research providers in pricing research as well as the possibility that due to the new rules, fewer brokers offer analysis of small and medium-sized enterprises (SMEs) and that a reduction in coverage may then affect SME financing and growth.

Markets in Financial Instruments Directive (MiFID II)

Effective since January 2018, MiFID II is the updated version of MiFID that was introduced in 2007 to provide a single regulatory framework for investment firms across the EU. Among other points, the revised directive aims to enhance investor protection in three ways:

- More detailed cost disclosure
- Enhanced product governance
- Addressing conflicts of interest


4 The research payment account must be funded by a specific research charge to the client; firms must set and regularly assess a research budget; firms must assess the quality of the research and whether it contributes to better investment decisions. Furthermore, firms must disclose to clients what is the budgeted amount for research and the estimated charges before they use the RPA as well as what the total costs for third party research have been once the RPA has been used.

Packaged Retail and Insurance-based Investment Products (PRIIPs)

The PRIIPs regime was designed to apply the high standards of disclosure that exist for open-ended funds through the EU UCITS directive to all investment-based products including those within an insurance or banking wrapper. The principal objective was to have the same key information document (KID) with the same metrics across all retail investment products, ensuring maximum comparability. Although the Level 1 regulation was adopted in 2014, delays to the technical standards meant a 12-month delay in the application of the regulation. The PRIIP KID regulation has been applicable since January 2018 on all products except UCITS.

The UCITS exemption was originally agreed on the grounds that the UCITS Key Investor Information Document (KIID) had recently been introduced and some time should be allowed for that to bed in. The exemption was scheduled to run until the end of 2019 but, given industry and consumer group concerns about the content of the PRIIP KID, it was agreed to extend the exemption by a further two years, until the end of 2021.

In the interim, the European Supervisory Authorities (ESAs) have been working on targeted amendments to the technical standards to address issues particularly around cost and performance disclosure:

- Costs are expressed as a reduction-in-yield (RIY) number which is inconsistent with MiFID II disclosures
- The methodology for estimating implicit transaction costs captures broader market movement, often resulting in negative transaction cost numbers whereas MiFID generally captures the prevailing spread (the cost between buying and selling a particular asset)
- Past performance is replaced by performance scenarios that are estimated based on past returns resulting in procyclical messages

The ESAs opened a consultation with the industry on specific proposals on 16 October 2019 while, in parallel, the European Commission is running consumer testing on the presentation of performance, the results of which are expected to be published in early 2020. The likely outcome is changes in the technical standards that will probably not address all known problems.

It remains to be seen whether more fundamental changes in the overarching regulatory framework will be left for a more comprehensive review of the PRIIPs regulation itself.

Alternative Investment Fund Managers Directive (AIFMD)

AIFMD provides a harmonised regulatory framework for managers of alternative investment funds (AIFs) across the EU. It came into force on 21 July 2011 and Member States were required to transpose AIFMD into national law by 22 July 2013. The benefit of compliance is the ability of an AIF manager to operate funds across the EU and to sell such funds to professional investors across the EU (‘passporting’). The requirements cover all aspects of an AIFM’s operation, such as conduct, remuneration, capital requirements and delegation. Although it primarily regulates the manager of an AIF and not the AIF itself, it also contains requirements on matters such as safekeeping of assets, leverage, liquidity management, valuation and pricing.

6 This was part of the cross-border distribution proposals agreed in 2019 – see below under ‘Capital Markets Union (CMU) initiatives’. 7 These are: the European Securities and Markets Authority (ESMA) supervising all activities in securities markets and most asset management activities fall under its remit; the European Insurance and Occupational Pensions Authority (EIOPA) that looks after insurance and pension fund products; and the European Bank Authority (EBA) that oversees the banking sector. National regulators are responsible for the supervision of individual entities such as asset managers whereas the role of the ESAs is ensure convergence amongst national regulators and that European regulation and supervision are efficient and harmonised. 8 Alternative investment funds include any collective investment undertaking – whether open-ended or closed-ended; authorised, listed or unregulated – that is not a UCITS.

The European Commission is currently reviewing the AIFMD framework and, to this end, commissioned KPMG in 2017 to examine the effectiveness of AIFMD implementation. The results of the study, published in January 2019, indicated that AIFMD has significantly contributed to creating an internal market for AIFs and that most of the AIFMD provisions have achieved their intended objectives ‘efficiently and effectively’. However, a number of areas requiring further in-depth analysis were also identified such as regulatory reporting, calculation of leverage, valuation rules, remuneration, depositary rules, asset segregation, and rules on disclosure to investors. Moreover, while the AIFMD passport was viewed as working well, the EU marketing passport was negatively impacted by the different approaches taken by national regulators on marketing, resulting in additional costs for the industry and investors.

Since then, the Commission has continued its review – as required by Article 69 of the Directive – with particular focus on the issues that KPMG identified for further reflection. This will culminate in a report that the Commission will prepare and submit to co-legislators in 2020.

Capital Markets Union (CMU) initiatives

Adopted by the Juncker Commission in 2015, the CMU Action Plan was the roadmap for creating a common capital market across the EU to complement the bank-based financing model prevalent particularly in continental Europe. The driving force behind this was the need for the real economy to have multiple and diversified sources of capital in order to grow and innovate and to maintain financial stability. Achieving this requires a multifaceted approach addressing corporate issuers, capital market infrastructure, and savers’ willingness to invest (directly or indirectly) in capital markets.

It is specifically the last point where consumer protection plays a role, in terms of whether markets are too fragmented or lack portable pension products or do not offer enough choice and competition to instil confidence in savers to invest.

With the new Commission, we see Member States increasingly calling for reviving the CMU project, with particular focus on retail markets and SME financing.

Cross-border distribution of retail investment funds

Cross-border distribution is a significant aspect of the CMU agenda aiming to increase access to products offered across the EU through targeted changes in the regulatory framework for UCITS and AIFs, and specifically aspects of distribution and marketing. These involve removing some of the barriers, mainly those of an administrative nature, to cross-border distribution of retail investment funds. Key changes include:

- Removal of the need for physical presence of paying agents in each Member State where the fund is registered, thus reducing the costs paid by the fund
- Aligning national marketing requirements and regulatory fees
- Harmonising the process for the verification of marketing material by national regulators
- Allowing managers of AIFs to ‘test the appetite’ of potential investors for new investment strategies

Legislation was adopted in June 2019 and ESMA is expected to submit a report about marketing requirements by 31 June 2021. Full application is required by July 2021.

Pan-European Personal Pension (PEPP)

As the only retail product coming out of the CMU project so far, the PEPP is effectively a personal pension that is portable across the EU, to promote saving for retirement and complement existing national pension provision. To achieve standardisation and portability, it was necessary to create a common framework for manufacturing, distribution and marketing.

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Other requirements include:

- The design should include a default fund (basic PEPP) with a guarantee allowing the recoup of any capital invested or alternatively with a life-cycle investment approach directed at ensuring capital protection. A further five investment options can be offered on the basis of a guarantee of ‘risk mitigation’ techniques to provide sufficient protection.
- Savers may switch once every five years free of charge and the basic PEPP will be subject to a fee cap of 1%.
- PEPPs are to be authorised in their home Member State but notified for sale in other Member States as per the UCITS model. EIOPA will be keeping a central register.

The overarching regulatory framework (‘Level 1’) was adopted in June 2019 and now regulators are discussing the technical implementation (‘Level 2’). This includes questions such as which components will be subject to the 1% fee cap for the basic PEPP, e.g. whether it will include the cost of advice, and how key information should be disclosed to investors.

Value for money
As part of the CMU agenda, the European Commission has been looking to foster investment in retail products in order to increase the amount of savings that is channelled to capital markets. A principal component of this is ensuring there is cost and performance transparency, and thus competition, in the retail investment market. This is aligned to the value for money agenda and has involved different workstreams for ESMA, looking principally at delivery and reporting of performance net of costs and charges.

- Recurrent costs and performance reports. ESMA received a mandate from the Commission in 2017 to carry out analysis on the costs and performance of retail investment funds on an annual basis. The objective was to ensure that disclosures are easily accessible and support retail investors in their choices but this exercise was also intended to support authorities and particularly the Commission in identifying market segments where investors ‘are in a sub-optimal situation’. This mandate has resulted in a number of reports discussing the performance of different groups of UCITS, the relationship between fees and performance, and a comparison between the delivery of active and passive funds. It remains to be seen whether the results will feed into a specific course of action but ESMA’s Securities and Markets Stakeholder Group has already highlighted data limitations that require further attention. These limitations concern data around distribution costs, total cost of ownership, and data for pension funds and structured accounts the lack of which affects the comparability of the ESMA report with similar reports from EIOPA and EBA.

- Performance reporting and use of benchmarks. In March 2019, ESMA updated its Questions and Answers document regarding the application of the UCITS directive to reflect new guidance around the disclosure of performance and the use of benchmarks. Specifically, the document had been amended to clarify that past performance must be shown compared to that of a target or comparator benchmark. It also featured new content around the meaning of ‘reference to a benchmark’, explaining that this is where the benchmark plays a role in the management of the fund. Specific examples of benchmark usage include where: the fund has an internal or external target to outperform; the fund is constrained by internal or external risk indicators that refer to a benchmark; part of the portfolio manager’s remuneration is connected to the fund’s performance relative to that index.

ESMA performance fee guidelines. In July 2019, ESMA launched a public consultation on draft guidelines on performance fees under the UCITS Directive. The principal aim was to harmonise the way in which performance fees can be charged to the UCITS and its investors while ensuring common standards of disclosure. The review will take stock of the overall approach to regulation of the financial services sector, including how the regulatory framework may need to adapt in the future, particularly in relation to when the UK leaves the EU. Specific points that ESMA is examining as part of this consultation include the consistency between the performance fee model and the fund’s investment objectives, strategy and policy, the frequency of the performance fee crystallisation and payment, the circumstances where a performance fee should be payable and the disclosure of the performance fee model.

A conclusion and the final guidelines are expected towards the end of 2019.

Going forward
It is very clear that transparency and value for money is a key priority for European regulators and this is reflected in a number of workstreams that run in parallel and have the ulterior objective of deepening the single market for retail investment products and increasing competition. Importantly, all regulation is subject to ongoing review. For example, in July 2019 ESMA issued a call for evidence on the impact of the inducements and costs and charges disclosure requirements under MiFID II. This is in context of the Commission needing to report before 3 March 2020 to the European Parliament and the Council of the EU on the impact of the inducement disclosure requirements. The Commission is looking at whether commission payments should be banned across the EU as is currently the case in the UK and the Netherlands. Should this happen, it would disrupt many financial services companies in the EU that are based on the bankassurance model.

Consistency of disclosure is going to be a main theme going forward particularly between MiFID II, UCITS, the Insurance Distribution Directive (IDD) and PRIIPs. This is at the same time as the PRIIP KID, which as discussed above is known to be problematic, is going to be the basis for the PEPP disclosure to investors. The questions for regulators will be whether the framework around MiFID II, UCITS, AIFMD needs to be amended, and if so, how.

Effectiveness of disclosure is going to be the next natural question, reflecting policymaker interest not only on transparency but also on what investors do with it and whether specific intervention is needed. In this context, the challenge for the industry is how it can better articulate how it delivers value for its clients and how to engage them with the information it provides.

9 Clarifications as to which cost components are included in this fee cap are currently discussed by the ESAs.
Section 2: Conduct

A major part of regulatory activity relates not to asset managers’ products but to asset managers as firms. Unsurprisingly, in the aftermath of the Financial Crisis, it is capital requirements and the broader prudential regime for asset managers that have been in the regulatory spotlight. But EU regulators have also looked at market abuse, money laundering and terrorist financing, and, in several contexts, remuneration. At the same time, there is a global effort to tackle tax avoidance, which although technically legal, may result in significantly reduced tax revenue for states and is an important conduct issue.

There is a further component of culture that is not well defined in regulation but embedded in regulators’ thinking, with a specific interest in corporate responsibility; that is, how asset managers behave as companies on issues such as promoting diversity. This is more prominently discussed in the UK – see Appendix 1 for more details.

Last but not least, regulatory attention on conduct is linked to initiatives on reducing financial stability risks and fostering more long-term investing.

Figure 3: Regulation at the firm level

Source: Schroders.

Remuneration

Remuneration for asset managers within the EU is subject to multiple regulations, including UCITS, AIFMD, MIFID II, and the Capital Requirements Regulation and Directive (CRR/CRD). Although there are some differences between these requirements, they all:

- Stem from the Financial Stability Board’s ‘Principles for Sound Compensation Practices’ from 2009
- Apply to senior managers, risk takers, and staff in the same remuneration bracket as senior managers and risk-takers
- Evolve around governance, incentives for risk-taking and disclosure

In terms of governance, the rules require establishing a remuneration committee as well as designing policies that are aligned with clients’ best interests and don’t give rise to conflicts of interest. In terms of incentives for risk-taking, the rules require that both quantitative and qualitative factors are used to assess performance during a multi-year framework and they prescribe the proportion of variable remuneration that must be deferred and for how long. In terms of disclosure, the rules broadly require that the remuneration policy is made available to national regulators and that it is publicly accessible.

One key difference between the regulations is that the CRR/CRD regime imposes a maximum ratio between fixed and variable remuneration – effectively a bonus cap – of 100% that can go up to 200% with shareholder approval. This has remained in place with the latest version, CRD V, which EU Member States have to implement by 28 December 2020. The changes include: increasing the minimum deferral periods from three-five years to four-five years; having gender-neutral remuneration policies; and revising the proportionality principle to exempt smaller institutions and certain staff members from some of the directive’s provisions. CRD V will, however, only apply to a very small subset of investment firms, which are deemed to be systemically important (for more details see Section 5).

Most asset management firms will fall under the new Investment Firm Regulation and the Investment Firm Directive (IFR/IFD) that will be effective from 2021 and replace the CRR/CRD rules for firms that are not deemed systemic. Although the change in the broader prudential rules is going to be significant, the remuneration rules under the IFR/IFD are consistent with the other requirements. It is worth noting, though, that IFR/IFD stress gender neutrality for remuneration policies and practices and, contrary to CRR/CRD, will not impose a bonus cap but allow Member States to do so at a national level.

Reporting under the new IFD/IFR regime has to be done separately under UCITS rules, AIFMD rules and the new IFD/IFR regime.

Outsourcing

In February 2019, the EBA published its revised Guidelines on outsourcing arrangements, which entered into force on 30 September 2019. The aim of these Guidelines is to establish a more harmonised framework for all financial institutions within the scope of the EBA’s mandate, namely credit institutions and investment firms subject to the CRD, as well as payment and electronic money institutions. The Guidelines provide more granular requirements on outsourcing arrangements. In particular, they clarify that:

- The management body of each financial institution remains responsible for that institution and its activities at all times
- The management body should ensure that sufficient resources are available to appropriately support and ensure the performance of those responsibilities, including overseeing all risk and managing the outsourcing arrangements
- Outsourcing must not lead to a situation in which an institution becomes an ‘empty shell’ that lacks the substance to remain authorised

Additionally, the Guidelines require firms to have an outsourcing policy that meets specific requirements, create and maintain an outsourcing register and ensure that certain internal governance arrangements are met. The Guidelines also require that contracts documenting the outsourcing arrangement include certain minimum provisions.

Data protection

Data protection in the EU is governed by the General Data Protection Regulation (GDPR) that came into force in May 2018 to strengthen and unify the protection of personal data for individuals within the EU and to address the export of personal data outside the EU. Replacing the Data Protection Directive, GDPR has granted individuals greater power to control their personal data held by companies and introduced a stringent regime for companies’ handling of personal data, including fines of as much as €20 million or 4% of a company’s global turnover.

The European Commission is currently planning to submit a report on the evaluation and review of GDPR to the European Parliament and Council. This work shall examine the application and functioning of:

- The transfer of personal data to third countries or international organisations
- Cooperation and consistency

If necessary, the Commission will submit appropriate proposals to amend this regulation. Any changes will be relevant for asset managers, particularly in terms of how they handle their clients’ data.
Financial crime

Anti-Money Laundering Directive (AMLD) VI

Money laundering has recently come under even greater regulatory scrutiny following a scandal relating to Nordic banks\(^1\). In light of this, the European Parliament published new anti-money laundering rules only half a year after the fifth AMLD had been adopted, signalling a strengthening in the EU's fight against money laundering and terrorist financing.

The sixth AMLD requires the introduction of new criminal law provisions to disrupt and block criminals' access to financial resources. The main changes include:

- Expanding the scope of money laundering offences to include aiding, abetting, inciting and attempting
- A unified list of predicate offences
- Extending the concept of criminal liability from natural to legal persons meaning that there will be corporate liability for offences
- Establishing a maximum term of imprisonment of (at least) four years while additional measures, such as exclusion from access to public funding or bans from conducting business, may be imposed
- Removing obstacles to cross-border judicial and police cooperation

Member States are required to transpose the Directive into national law by December 2020 and entities within its scope need to implement the new rules by June 2021.

As an additional signal that this will be a priority for the EU going ahead, the recent review of the European System of Financial Supervision (ESFS)\(^2\), granted EBA an enhanced role in the supervision and enforcement anti-money laundering rules across financial services, including firms outside the banking sector such as asset managers. Nevertheless, there remain concerns that the ESFS review has not sufficiently changed EBA's governance to ensure independence and there are calls from some EU Member States to create a new EU supervisory authority dedicated to money laundering and terrorist financing.

Market Abuse Regulation and Market Abuse Directive (MAR/MAD)

MAR and MAD provide the regulatory framework to prevent all forms of market abuse, such as insider trading, sharing of insider information and market manipulation. This is essential for market integrity and investor protection as well as for ensuring capital markets are a credible alternative for raising capital, which is the overarching CMU objective.

MAR/MAD have applied since July 2016 and are closely aligned with MiFID II. The most important change in comparison to the previous requirements has been to turn much of the requirements of the directive into regulation, thus ensuring maximum harmonisation across Member States.

As with other EU regulation, MAR includes a provision requiring the European Commission to present a report to the Parliament and the Council on the impact and effectiveness of the regulation. In this context, ESMA launched a consultation in October 2019 seeking stakeholder views on a range of issues such as:

- The possible inclusion of spot FX contracts within the scope of MAR\(^3\)
- The definition and delayed disclosure of inside information in different cases

11 For more details, see Financial Times, *Inside Danske's €200bn 'dirty money' scandal*, 3 October 2018

12 The ESFS was set up in 2010 to strengthen financial supervision and consists of the three ESAs (ESMA, EIOPA and EBA) which supervise individual sectors and institutions (micro-prudential pillar) and the ESRB that oversees the overall financial and coordinates EU policies for financial stability (macro-prudential pillar). The ESFS review started in 2017 examining issues around governance, funding and supervisory powers and the *Final framework* was agreed in March 2019.

13 Spot FX contracts are currently out of scope of both MAR and MiFID II.

- The appropriateness of the trading prohibition and insider lists for persons discharging managerial responsibilities
- A possible cross-market order book surveillance framework
- Cross-border enforcement of sanctions

This exercise will result in a report that ESMA will submit to the European Commission in spring 2020.

Tax avoidance

Tackling tax avoidance is a priority not only for European policymakers but for governments across the world. OECD and G20 have developed a framework to address base erosion and profit shifting (BEPS), which refers to tax planning strategies used by multinational enterprises in order to exploit gaps in tax regulation and avoid paying tax. The main objective of the BEPS framework is to ensure that profits are taxed where the economic activities generating the profits are performed and where value is created.

This work started in 2012 culminating in a detailed action plan in 2013\(^4\) and an Inclusive Framework in 2016 that now includes over 130 counties and jurisdictions. The BEPS package is made of 15 actions, the first of which relates to the tax challenges raised by digitalisation. The two main questions are how taxing rights arising from cross-border activities should be allocated and whether digitalisation has facilitated tax avoidance.

This is currently the top priority for the OECD/G20 Inclusive Framework and has been a crucial point from the start. OECD/G20 issued a policy note in January 2019 proposing two complementary pillars:

- Pillar 1 – re-allocation of profit and revised nexus rules: this explores potential solutions for determining where tax should be paid and on what basis ('nexus') for income generated from cross-border activities, and what portion of profits should be taxed in the jurisdiction where clients are located ('profit allocation')
- Pillar 2 – global anti-base erosion mechanism: this explores the design of a system that will ensure multinational enterprises in a digital economy pay a minimum level of tax

The intention is to develop a consensus-based solution by the end of 2020.

For asset managers, this may mean that tax will effectively shift from where regulated asset management operations are located to where the asset managers’ clients are. In a context of increasing cross-border activities (which indeed is one of the CMU priorities) and distribution of products and services online this would mean a considerably larger tax footprint globally, increased administrative cost and the potential for double taxation.


Going forward

The digital economy and what this means for data protection, tax and financial crime is likely to feature quite prominently on the agenda for the incoming European Commission. Moreover, with the current AIFMD review and expected UCITS review, there could be changes on issues such as remuneration rules, particularly in respect to gender diversity as we have seen with CRD V and IFR/IFD.

A notable feature of firm level regulation is that it is shaped by multiple directives. Conflicting approaches to regulation, not only on remuneration but more generally on conduct, would be a significant challenge. In the same way as consistency of disclosure is important for consumer protection, consistency of firm level rules is important for operational effectiveness and a level playing field and, as a result, better client service.
Section 3: Sustainable investment

Sustainable investment has been on policymakers’ agenda for many years, particularly after the 2008 Financial Crisis, when attention was given to the question of how to foster more long-term investment thinking. Policy considerations accelerated in the context of the Paris Climate Agreement and increased civil society movements on climate change mitigation. Sustainable investment is still an area of constant development and sometimes rapid change with an equally evolving terminology. What previously ran under ‘ethical’ or ‘responsible’ and was considered as rather niche, complemented by considerations on how asset managers act as shareholders and ‘stewards’ of public companies, is now rapidly becoming more and more mainstream.

While the Shareholder Rights Directives I and II formalised existing best practices, particularly around having relevant voting policies in place, reflections have broadened from corporate governance issues to environmental risks and social impact. In parallel, sustainable investment strategies have shifted from pure screening or ‘best in class’ to more comprehensive, integrated methodologies.

The big political push has come with the European Commission’s Action Plan on Financing Sustainable Growth, published in March 2018. The Action Plan contains ten specific initiatives, all with the objectives to re-orient capital flows towards sustainable investments, mainstream sustainability into risk management and foster transparency and long-termism. EU policymakers now regard sustainable investments as part of the CMU agenda, hence the scope covers a wide range of issues and actors in the financial services market and within the investment chain. It is worth noting that while the initial agenda looked at environmental, social and governance (ESG) factors, policymakers’ attention is increasingly focusing on climate change and decarbonisation as the most pressing topics.

Below we cover those parts of the Action Plan that we consider to be most pertinent for asset managers currently.

Taxonomy Regulation

The proposed regulation establishes the conditions and the framework to gradually create a unified classification system (‘Taxonomy’) on what can be considered an environmentally sustainable economic activity. Based on this framework, technical screening criteria (‘Level 2’ measures) will be developed based on the advice of the Technical Expert Group (TEG). With this proposal, the European Commission ultimately aims at defining a common language on sustainable investments, which would prevent so called “green-washing” and set a certain standard, possibly to be used for national and/or EU labels.

The technical screening criteria would first target climate-related aspects and later other ESG areas.

Negotiations amongst the co-legislators are still ongoing, with difficult questions to answer, such as how to categorise transition activities and how to link disclosures required by the taxonomy framework to those in the Sustainability Disclosure regulation.

Sustainability Disclosure Regulation

This Regulation requires financial institutions to disclose procedures on integrating ESG risks in the investment process, the extent to which these risks impact the investment performance and the non-financial impact of investments on ESG factors. The main objective is to avoid green-washing and make it easier for end-investors to make informed choices when buying products marketed as sustainable investments.

The Regulation will require financial market participants including asset managers to publish (mostly within pre-contractual disclosures):

- Information on policies on integrating sustainability risk in the investment decision making process
- Information on policies regarding ‘principal adverse impacts of investment decisions on sustainability factors’ at entity and product level (‘comply or explain’ for firms below 500 employees, obligatory above this threshold)
- Information on integration of sustainability risks in remuneration policies
- A description of how (financial) sustainability risks are integrated in investment decisions
- For products marketed as sustainable: information on how sustainability characteristics or objectives are met and how a reference benchmark aligns with those characteristics/objectives

Implementation is expected to require significant changes in the investment process, prospectus and marketing material throughout the asset management industry.

Regulators are currently developing technical details (‘Level 2’) supplementing the requirements in the regulation. While the principal requirements will become effective in Q1 2021, technical details will follow soon thereafter.

Figure 4: Regulatory focus on sustainable investment and stewardship

Source: Schroders.
EU Low Carbon Benchmarks
The reason for this new regulation is a perceived lack of appropriate and objective indices that could be used as a reference index for sustainable investments. At the same time, increased transparency on sustainable indices’ methodologies is necessary to supplement enhanced disclosure on the investment product itself (see above ‘Sustainability Disclosure Regulation’).

The regulation establishes two new types of benchmarks (amending the EU Benchmark Regulation):

- EU Climate Transition Benchmarks: these take into account companies that follow a measurable, science-based ‘decarbonisation trajectory’ by end-2022, aligned with the Paris Agreement’s global warming target
- EU Paris-aligned Benchmarks: these have a more ambitious goal to select only companies that can contribute to attaining the 2°C reduction set out in the Paris agreement

All benchmarks will be obliged to provide an explanation of how ESG factors are reflected in their investment strategy and how the methodology aligns with the target of reducing carbon emissions.

The regulation will become effective in Q1 2021 and regulators are currently developing technical details (Level 2) supplementing the requirements in the regulation.

EU Ecolabel
As part of its Action Plan on Sustainable Finance, the European Commission intends to create EU Ecolabels for financial products. The Joint Research Centre (JRC) has started work on developing EU Ecolabel criteria, focusing on ‘green’ financial products through draft reports and consultations. Considerations cover general questions such as products scope and definitions, mandatory versus optional criteria, but also detailed criteria such as portfolio thresholds, excluded activities and assessment of companies and verification processes. As described above, it is likely that the taxonomy will form the basis – to a certain extent – for a product to be approved to carry the EU Ecolabel.

The JRC has held some rounds of stakeholder consultations, with final proposals scheduled for early 2020. The European Commission envisages adopting a formal decision by November 2020.

Integration of sustainability in MiFID II, UCITS and AIFMD
According to the European Commission, institutional investors and asset managers don’t systematically take into account sustainability factors and risks in their investment process, creating a blank spot in the context of fiduciary duty. While the Sustainability Disclosure Regulation requires transparency on sustainability integration in the investment decision making process, amendments to MiFID, UCITS and AIFMD establish minimum requirements as to how this integration needs to be reflected in the operational and organisational set-up. Specifically, the European Commission will propose amendments to the technical details (Level 2) of MiFID, UCITS and AIFMD, incorporating requirements on governance and oversight, conflicts of interest and risk management.

Additionally, the European Commission believes that if firms systematically ask investors about their sustainability preferences, more funds will be reoriented towards sustainable investments. Therefore, the European Commission will propose to incorporate sustainability when providing financial advice by amending the delegated acts under MiFID II. This includes additions to the suitability assessment, the identification of target markets and arrangements to avoid conflicts of interest.

It is expected that legislative proposals will be published in Q4 2019 and that entry into application will be aligned with that foreseen in the Sustainability Disclosure Regulation.

Shareholder Rights Directive
The European Shareholder Rights Directive II (SRD II), amending SRD I (which had come into effect in 2007), seeks to encourage long-term shareholder engagement and enhanced transparency between companies and their shareholders. A principal component of this is enhanced transparency around institutional investors and asset managers’ stewardship activities. Specifically, SRD II requires that institutional investors and asset managers:

- Develop and publicly disclose a policy on engagement or explain why they choose not to do so
- If a policy is published, describe how they monitor and conduct dialogues with investee companies, how they cooperate with other stakeholders and communicate with relevant stakeholders, and how they manage actual and potential conflicts of interests
- Publicly disclose, on an annual basis, how their engagement policy has been implemented, including how they have exercised their voting rights, particularly for significant votes
- Report on the use of proxy advisors

The deadline for EU Member States to transpose the Directive into national law was June 2019, with the requirements to apply from September 2020. Recent information shows that some Member States have missed the transposition deadline.

Going forward
With sustainability one of the top priorities of the incoming Commission, it is clear that the political focus on this issue is here to stay. Moreover, policymakers recognise sustainable investments as a component of the CMU, another pivotal project for the EU. Undoubtedly, asset managers have an important role to play, not least by ensuring transparent and objective communication to clients. As sustainable investments are a dynamic market which has just started to receive greater regulatory focus, it is important that too detailed and terminology-focused regulatory response doesn’t impede further analysis and improved understanding of the risks and opportunities involved.

We expect the European Commission to concentrate on non-financial corporate reporting and European labels in 2020, as well as on developing a green financing strategy. Last but not least, we will likely see increased efforts by the European Commission to establish the EU sustainability framework as an international standard.
Section 4: Capital markets

Capital markets are the most essential component in investing, providing the pipework and infrastructure needed to make investment possible. The capital market ecosystem includes asset managers and other entities such as investment banks and brokers, execution venues (e.g. stock exchanges), custodians, market utilities (e.g. trade repositories), clearing houses and technology providers. Asset managers are part of what is commonly referred to as the ‘buy-side’ whose investment activity generates the revenue for the rest of the ecosystem. This reflects the cost that must necessarily be incurred to access capital markets.

As with other aspects of regulation relevant for asset managers, the regulatory regime for capital markets has been significantly restructured since the 2008 Financial Crisis. There have been broadly three focal areas:

- Pre- and post-trade transparency
- Changes in execution and clearing
- Requirements around conduct and the handling of conflicts of interest that could affect outcomes for end-clients (discussed in Section 1)

The overarching aim is to prevent opaque practices that led to the build-up of significant risks in the system before the Crisis and to ensure there are no barriers to the smooth functioning of financial markets. This is crucial for price discovery and market efficiency as well as for investor confidence in these markets.

Figure 5: Regulatory priorities for capital markets after the 2008 Financial Crisis

Pre- and post trade transparency

Conduct and conflicts of interest

Execution and clearing

Source: Schroders.

MiFID II

Share trading obligation

According to MiFID II, all EU-traded shares must be traded on an EU regulated market. This includes trading venues within the EU or markets outside the EU that are deemed to be equivalent. A potential side-effect of this requirement is that it might create liquidity issues for asset managers where a specific regulated market has only a limited volume of shares for a given financial instrument.

Brexit has created additional challenges particularly around the question of whether a share that is primarily listed outside the EU can only be traded in EU venues. ESMA clarified in May 2019 that shares with a UK ISIN would not be in scope for the EU share trading obligation, but there are still concerns around the trading of EU listed shares that are mainly traded on UK venues (which have not yet been granted equivalence for EU share trading obligation purposes).

Consolidated tape

Consolidated tape is an electronic, continuous feed of real time trading data, where each entry shows the security traded as well as the volume and price of the trade. This is a key feature of (post) trade transparency in capital markets. One important contribution of MiFID II has been the setting of the regulatory framework needed to establish a market-based solution for the provision of consolidated tape across the EU. However, even though MiFID II has been in place for almost two years, the EU market has yet to deliver this. According to ESMA15 this is due to three reasons:

- Providing consolidated data does not make for an attractive commercial proposition, given the high cost involved in setting up the necessary system and procuring all relevant data16, the lack of a regulatory requirement for market participants to buy consolidated tape data, and the fact that all data would need to be made available free of charge 15 minutes after publication
- The provision of consolidated tape is subject to strict regulatory requirements and the provider would be subject to both authorisation and ongoing supervision
- The same service can be provided by non-regulated entities such as data vendors

Considering the importance of trade transparency for capital market efficiency, MiFID II had already included a provision for the European Commission to carry out a review. As part of it, ESMA carried out a consultation in summer 2019 on ways in which the framework can be amended, such as mandating the provision of data by trading venues to consolidated tape providers and improving data quality by harmonising data and standardising reporting and consistency. The outcome of this consultation will be shared with the Commission towards the end of 2019 and then the Commission will present a report to the European Parliament and the Council.

European Market Infrastructure Regulation (EMIR) Refit

EMIR was the outcome of a G20 Summit in Pittsburgh in 2009 where a number of commitments were agreed to bring more transparency to market trading and particularly to the opaque, ‘over-the-counter’ (OTC) derivatives market. This was in direct response to the 2008 Financial Crisis. In a nutshell, EMIR imposes three categories of requirement: risk mitigation requirements and the provider would be subject to both authorisation and ongoing supervision

15 ESMA Consultation Paper, MiFID II/MiFIR review report on the development in prices for pre- and post-trade data and on the consolidated tape for equity instruments, ESMA70-156-1065, 12 July 2019
16 For example, ESMA estimates that to procure the data needed to include 100% of equity instruments in the EU, would require buying data from more than 150 sources and costing about EUR 10 million per year.
EMIR came into force in 2012 and underwent a review by the Commission in 2015-2016. This process was part of the Commission’s ongoing work that includes periodical reviews of regulation to see if improvements are needed. The review of EMIR concluded that it works well overall but nevertheless identified some areas requiring simpler and more proportionate rules. The European Commission published a series of proposals in May 2017, and following agreement between co-legislators at the end of 2018, a regulation updating certain aspects of EMIR (known in the industry as the ‘EMIR Refit’) entered into force in June 2019. Among other points, EMIR Refit:

- Creates a new category of ‘small financial counterparties’, which are out of scope for the EMIR clearing obligation
- Reduces the reporting obligations for smaller non-financial counterparties (NFC), for which the relevant reporting will be performed by the FC trading counterparties (with effect from June 2020)
- Extends the clearing exemption for eligible pension scheme arrangements by another two years (until 18 June 2021)\(^{11}\). This exemption had been initially granted due to a recognition that pension schemes typically minimise their allocation to cash in order to maximise efficiency and returns for beneficiaries. As a result, the need to meet the collateralisation requirements of CCPs would lead pension schemes to have to divest a significant proportion of their assets for cash, for which there remains no viable solution
- Streamlines reporting obligations by removing the obligation to report historic data (‘backloading’) as well as intragroup transactions involving non-financial counterparties
- Adds a new obligation on clearing brokers to provide services on fair, reasonable, non-discriminatory and transparent commercial terms (‘FRANDT’) to improve client access to clearing
- Requires CCPs to provide their clearing members with a tool allowing them to estimate (on a non-binding basis) the amount of additional initial margin that the CCP may require upon the clearing of a new transaction

These changes will have direct implications for clients and funds established in the EU and trading in derivatives. Indirectly, certain non-EU funds and clients trading with EU counterparties may be affected as well.

**Securities Financing Transaction Regulation (SFTR)**

The SFTR aims to create a safer and more transparent financial system by placing additional requirements on counterparties to securities financing transactions (SFTs). It is the European Commission’s response to the Financial Stability Board’s (FSB) proposals from 2013\(^{17}\) and concerns around financial stability. Effectively, it aims to improve transparency by:

- Imposing conditions on how collateral can be ‘re-used’, requiring consent by the counterparty to relevant collateral arrangements and the exchange of information on the risks and consequences of entering into such arrangements
- Requiring managers of UCITS and AIFs to disclose to investors, via periodic reports and prospectuses or equivalent documentation, information on the use of SFTs and Total Return Swaps (TRS), such as the amount of assets engaged in an SFT, how counterparties were chosen, what the top ten counterparties are, how much collateral has been received and how much of it has been re-used etc.
- Requiring counterparties using SFTs to report relevant details of such transactions to an authorised trade repository

SFTR entered into force in January 2016 on a phased-in basis, so that specific requirements were introduced at various points between 2016 and 2019. As with EMIR, the reporting requirements under SFTR apply to the counterparties to relevant transactions, i.e. on the buy-side, typically to asset managers’ underlying funds and clients. For those underlying funds and clients that are financial counterparties such as pension schemes, insurance companies etc. the reporting obligation will enter into force from October 2020. Non-financial counterparties will be subject to the reporting obligation from January 2021.

The need, in some instances, to provide relevant information to counterparties in advance of these go-live dates to facilitate the performance of their reporting obligations (which will enter into force in April 2020 for those counterparties that are credit institutions) may effectively mean that data capture and drawdown mechanisms, in respect of transactions entered into by asset managers on behalf of their underlying principals, will need to be in place well in advance of the reporting start date(s) applicable to such principals.

**Interbank Offered Rate (IBOR) reform**

The IBOR reform is the result of the London Interbank Offered Rate (LIBOR) manipulation scandal that came to light in 2012. In what proved to be a design flaw, the methodology used for the calculation of LIBOR was based on a survey of selected banks on the rate that they believed they could borrow from other banks. This led to misconduct that then spurred a review in the UK and efforts from other policymakers, such as the FSB and the International Organization of Securities Commissions (IOSCO) to reform LIBOR, as well as other key IBORs, to move to overnight risk-free rates that are based on actual transactions.

These reforms have been accelerated following remarks in 2017 by Andrew Bailey, Chief Executive of the Financial Conduct Authority (FCA), that the use of LIBOR is expected to be discontinued by the end of 2021. This means that the market effectively has until the end of 2021 to replace LIBOR with an alternative reference rate.

As a market (instead of regulator) driven reform, it affects institutions globally, and jurisdictions across the world are preparing for it, albeit at different rates. The scale of the transition should not be underestimated. According to the Bank of International Settlements (BIS), as of mid-2018, about $400 trillion worth of financial contracts referenced LIBOR\(^{19}\).

From an investment standpoint, impacted business areas for asset managers include:

- Where IBOR based products are held in their clients’ portfolios, for example LIBOR-based derivatives for hedging
- Where IBOR is used as a benchmark or performance target, e.g. for absolute return funds
- Where IBOR serves as an input to various internal calculations such as for discounting and valuation of assets, for stress testing etc.

The transition will also have a significant effect both in the legal documentation and operational practices for impacted entities. Anticipating that a new range of reference rates will need to be in use by the end of 2021, the main priorities for asset managers in 2019 are ensuring that they understand the changes and are actively preparing for the transition across all relevant areas, taking particularly into account conduct risk implications. For some asset managers the process may involve simply updating prospectuses of some funds to reflect the changes. For others, such as those engaged in liability driven investment or reviewing the terms of fixed income instruments, moving to the new rate is going to require much more engagement, e.g. where they have invested in 20-year instruments based on an IBOR.

\(^{17}\) The Commission can extend this exemption twice for a period of one year.


\(^{19}\) A. Schrimpf and V. Sushko, *Beyond LIBOR: a primer on the new reference rates*, BIS Quarterly Review, March 2019
**Taxation**

**VAT treatment of financial services**

In general, the supply of financial and insurance services in the EU benefits from VAT exemption. In relation to asset managers, the management of many types of collective investment schemes is exempted from VAT. This is to ensure tax neutrality between direct investment and the indirect or collective investment (as an investor investing directly does not suffer VAT on the acquisition and sale transaction relating to his/her portfolio of shares and securities). Periodically, European regulators look at aspects of the VAT system with a view to ensuring the proper functioning of the internal market.

In this context, the European Commission has initiated a review of the VAT rules for financial services and has commissioned a third party to carry out a study on the functioning of the current VAT rules with a specific focus on their cross-border dimension. The research, that includes field work in a number of EU countries, has already started and a final report with conclusions is expected in summer 2020.

A change in the scope of the exemption may have significant consequences for asset managers and their clients in the form of increased financial cost for one or both parties.

**Financial Transactions Tax (FTT)**

The possibility of an EU-wide tax on financial transactions has been a topic of debate since the initial proposals in 2011. At the time, the proposals were blocked by the Council but a number of Member States, including France, Germany and Italy, continued examining this, resulting in a proposal for an ‘enhanced cooperation’ according to which a common FTT would apply to the (ten) countries that are part of this cooperation. There was little progress until Germany and France decided to take this forward, making formal proposals in January 2019 that were discussed on several occasions throughout 2019. The main points of the proposals are:

- A French-style FTT to be levied on the acquisition of shares of listed companies with a head office in a Member State and a market capitalisation of over €1 billion
- The tax rate should be at least 0.2%
- Initial public offerings, market making and intraday trading will not be taxable
- The revenue will be levied nationally and distributed among Member States according to a mechanism that remains to be defined

The latest discussions took place in September 2019 but there is still no clear consensus on some aspects such as the exemptions for market makers and how to harmonise the revenue sharing between the participating Member States. Moreover, an enhanced cooperation on FTT should not create any disadvantage for non-participating Member States nor be a barrier to EU-wide tax harmonisation, thus leading to fragmentation within the Single Market.

It remains unclear whether an EU-wide FTT will be established but if it is, it may have a significant effect on market liquidity as well as create imbalances between jurisdictions. There would also be an additional cost for asset managers’ clients that want to invest in listed companies that have their head office in a country where the FTT applies.

**Crypto-assets**

In January 2019, ESMA published *Advice* outlining what it considers to be gaps and issues within its remit if crypto-assets qualify as MiFID financial instruments and risks if they do not qualify. Examples of identified gaps are lack of clarity around the types of services that qualify as custody/safekeeping, lack of certainty around the concept of settlement, and lack of protocol and smart contracts ensuring that crypto-asset activities meet minimum reliability and safety requirements. ESMA’s advice to policymakers was to develop and implement a bespoke regime for specific types of crypto-assets.

**Going forward**

This theme is closely linked with the next one: financial stability. For example, the rules introduced by EMIR changed the structure in the derivatives market and SFTR brought about more transparency in swap and securities lending transactions, resulting in more resilient and efficient capital markets (this, unsurprisingly, has a consumer protection aspect as well).

The flipside of this range of new and untested requirements could be unintended consequences if regulation becomes too rigid, imposing barriers to the effective functioning of capital markets. Current and planned reviews of major regulatory initiatives such as MiFID II and EMIR are intended to identify issues and seek to remediate them if necessary.

Brexit and the risk of further market segmentation is likely to play a key role in this. EU market rules have been calibrated with the UK as EU Member State in mind. This is particularly obvious in the case of thresholds applying to pre- and post-trading requirements. Once the UK leaves the EU, the calibration will need to be reconsidered.

Moreover, in the context of strained public finances, taxation, and particularly issues like the FTT, are likely to remain on the agenda.
Section 5: Financial stability

Financial stability still features high on the regulatory agenda more than ten years after the Global Financial Crisis and despite the substantive regulation that followed. With EU financial markets dominated by the banking sector, banks were, unsurprisingly, the immediate focus for policymakers. Asset managers are increasingly coming under the spotlight, not least because of the rapid growth of assets under management globally, which itself is partly the outcome of expansive monetary policies to address the downturn after the crisis.

The amount of assets managed is not directly relevant to the ‘too big to fail’ discussion as asset managers are agents rather than principals and do not hold client assets on their balance sheets. This means that there is far less interconnection between asset managers and funds compared to banks and their clients (and indeed, other banks).

Nevertheless, asset managers are subject to capital requirements, some of which had been initially designed for banks. And the regulatory focus does not stop at the firm level but goes deeper into the features of asset managers’ products. All of this runs parallel to specific interventions that are not directed at asset managers but at the broader capital market within which they operate. Issues of structure and liquidity as well as investor behaviour are part of the discussions.

Figure 6: Main considerations in the context of financial stability

![Diagram]

- Prudential requirements
- Liquidity mismatch
- Use of leverage
- Investor behaviour
- Liquidity
- Infrastructure: central clearing

Source: Schroders.

Firms

Prudential framework

The Investment Firm Regulation (IFR) and Investment Firm Directive (IFD) together make up the new prudential framework for asset managers (‘investment firms’) that will be effective in 2021 and is more tailored to the agency business model compared to the previous CRR/CRD regime that had principally been designed for banks. The key aims of IFR/IFD are to simplify and make more proportionate and risk-sensitive rules for investment firms with regards to capital holdings, reporting and corporate governance.

More specifically on the new prudential classification, according to the new rules investment firms will be categorised in different classes that determine their capital charges. The very large ones (‘class 1’ and ‘class 1 minus’) are ‘systemic firms’ and deal on their own account and/or underwrite or place financial instruments on a firm commitment basis. These remain subject to the full banking prudential regime (CRR/CRD) while IFD/IFR will apply to the other classes. The majority of investment firms will be within ‘class 2’ where capital charges are determined according to firms’ size, activities and risk profile. The others (‘class 3’) that are small and not interrelated will have minimum capital requirements.

It is worth noting that, at the same time, the new IFR/IFD regime sets out a more stringent equivalence assessment process for third-country investment firms that are likely to be systematically important for the EU although the technical standards (‘Level 2’) for the definition of what is ‘systemically important’ are yet to be determined.

Products

Products as a focal point for financial stability originates from an FSB report highlighting two ‘structural vulnerabilities’ within the asset management sector, namely the mismatch between the liquidity of funds and the liquidity of funds’ underlying assets, and the use of leverage either through direct borrowing or indirectly through derivatives (synthetic leverage). The FSB tasked IOSCO with examining how to manage liquidity risk and how to ensure there were consistent measures of leverage. In parallel, the European Systemic Risk Board (ESRB) has been examining these topics as well and in early 2018 issued a number of recommendations for specific actions that ESMA and the European Commission should take.

In this context, a recurring theme is the availability and reporting of relevant data to clients and regulators. Leverage can be measured in different ways, for example by looking at gross or net exposures, and the priority in this space is to achieve consistency (see below). Liquidity is less straightforward to quantify. Commonly defined as the number of days it takes to liquidate a position, i.e. to turn it into cash, it is affected by both subjective estimation and market conditions. The problems encountered with the recently introduced ‘liquidity buckets’ in the US (see Appendix 2) are indicative of the unreliability of liquidity metrics. Even more difficult to quantify, is the degree of liquidity mismatch between a fund and the underlying assets. This is why recommendations from IOSCO and ESRB are focussed mainly around setting and overseeing risk management processes rather than introducing rigid and potentially misleading metrics.

Liquidity

IOSCO recommendations around liquidity risk management tools were published in February 2018. Among others, these included having effective liquidity risk management processes in place, setting suitable dealing frequency, considering effects of distribution channels, disclosing risk and risk management processes to investors, carrying out stress testing and assessing liquidity on regular basis and having a degree of independent oversight.

The ESRB recommendations to ESMA and the Commission were about making a diverse set of liquidity management tools available to fund managers across the EU, taking measures to prevent excessive liquidity mismatches in open-ended AIFs, and developing guidance on stress testing. Responding to this, ESMA issued new guidelines on liquidity stress testing for UCITS and AIFs in September 2019, such as:

- Setting internal liquidity limits
- Carrying out a liquidity stress test at least annually and, where appropriate, employing it at all stages in a fund’s lifecycle (the guidelines recommended a quarterly frequency but allowed flexibility based on the fund’s characteristics such as scale, complexity and liquidity profile)
- Adapting liquidity stress testing scenarios appropriately with further specification that the scenarios employed should be both hypothetical and historical, and where appropriate use reverse stress testing as an optional tool
- Incorporating scenarios relating to the liabilities of the fund, including both redemptions and other potential sources of risk to liquidity emanating from the liability side of the fund balance sheet

20 Financial Stability Board, Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, 12 January 2017
21 IOSCO, Recommendations for Liquidity Risk Management for Collective Investment Schemes, Final Report, February 2018
Incorporating risk factors to the stress testing that are related to investor type and concentration according to the nature, scale and complexity of the fund. These guidelines will apply to all types of investment funds, including ETFs and money market funds, by September 2020.

Leverage
IOSCO’s work on leverage is still ongoing. It evolves mainly around a consultation paper published in November 2018, looking at how to develop consistent measures of leverage to improve reporting and enable comparisons. The proposal included a two-step process, with Step 1 using broad measures to be provided by all funds in order to filter out for further investigation at Step 2 those funds that could be considered high risk (from a financial stability perspective). Notably, it was proposed that national regulators maintain a degree of discretion on how they approach Step 2 while Step 1 is about having consistent measures for leverage. The final report is expected in Q4 2019.

The ESRB on the other hand focused on the use of macroprudential tools to limit leverage in AIFs, aiming to ensure a common approach that could include leverage limits and a set of indicators to be used by national regulators. ESMA guidance on this subject is expected in the near future.

Capital markets
Capital markets are central to financial stability and policymakers’ thinking in this context encompasses both investor behaviour within capital markets and the market infrastructure itself. Although investor behaviour itself is not subject to regulatory supervision, regulators do consider possible effects of issues such as herding, where investors tend to take similar decisions as others without their own assessment, or procyclicality, where investors follow the market cycle and buy when markets grow and sell when markets contract. This is more a consideration of what may happen under normal and stressed conditions rather than part of an intervention to eliminate this behaviour. Transparency and investor education can help facilitate progress in this area.

Furthermore, there is increased scrutiny of the rise of passive investment and use of ETFs and what this could mean for market efficiency, price discovery and the possibility of bubbles being created in the system. Given that the trend towards passive in Europe has not been as steep as the one in the US, this is currently being monitored.

Beyond investor behaviour, regulatory intervention has focused more on the structure of capital markets, and in the aftermath of the Financial Crisis, particularly on derivatives markets. Currently, the main item on the regulatory agenda is derivatives clearing and specifically the recovery and resolution of clearing counterparties.

Central Clearing Counterparty (CCP) Recovery and Resolution
Central clearing counterparties have risen in prominence and now have a central role in capital markets as a direct consequence of EMIR, which required the opaque and complicated network of bilateral OTC derivative contracts to be cleared centrally through CCPs. Figure 7 provides an illustration of the efficiencies that can be achieved with central clearing.

This structural change aimed to address the lack of transparency around large bilateral positions combined with insufficient collateral that led to the 2008 Financial Crisis. By doing so, the market moved from a large number of dispersed agreements to a small number of large and concentrated entities that clear the majority of positions. Hence, it has increased both concentration and interconnectedness creating the potential for significant market disruption and contagion if a CCP itself fails.

It is not surprising that regulators have strongly focused on the framework for recovery and resolution of CCPs. The European Commission has revisited the role of non-EU CCPs providing clearing services to EU-based counterparties. The main changes reflect a more pan-European approach to the supervision of CCPs that effectively make it more difficult for non-EU CCPs to provide clearing services within the EU. This will be particularly relevant in the context of Brexit. The proposed changes include:

- Establishing a new supervisory committee within ESMA and, while national regulators maintain supervisory responsibility, ESMA will be able to submit an opinion on specific cases
- Giving power to the Commission to refuse non-EU CCPs to provide clearing within the EU following a fully reasoned assessment by ESMA concluding that a CCP or some of its services are of systemic importance
- Stringent requirements for ‘Tier 2’, i.e. systemically important third-country CCPs operating in the EU that now shall comply with additional risk mitigation requirements

Following Brexit, the three CCPs based in the UK will de facto become third-country CCPs.

The Council adopted the revised rules in October 2019 and the regulation will enter into force in December 2019.

Going forward
Concerns around the volume of asset management activities and their potential to destabilise markets or exacerbate market stress are not abating despite multiple guidelines and regulation. In this context, it is important to apply policy tools that are designed for asset managers and investment funds rather than adapt approaches that have been developed with the banks’ business model in mind. It is equally important to take a principles-based approach that does not place substantial restrictions that could harm clients, such as prohibiting investment in illiquid assets altogether.

One interesting dimension of policymakers’ concerns whether a growing asset management sector poses risks for financial stability, is the obvious tension with the CMU agenda, which reflects policymakers’ efforts to make capital markets grow. CMU, as discussed above, is intended to act as a financial stability mechanism through the diversification of channels through which companies can raise financing.

Further EU regulatory action around financial stability is likely to depend on whether the widely anticipated economic downturn really occurs and, if so, how it unfolds. Brexit and the extent to which it may be disruptive for markets could also play a role in how much EU policymakers prioritise this theme.
Appendices
Appendix 1: Regulatory developments in the United Kingdom

Consumer protection

Over an almost three-year period between 2016 and 2018, the Financial Conduct Authority (FCA) carried out an extensive review of how competition works in the asset management sector in the UK – commonly referred to as the FCA’s asset management market study. The main conclusion was that there is not enough price competition in some segments of the market. A broad package of remedies was introduced in waves between 2018 and 2019, including a requirement for asset managers to carry out a value assessment of their UK authorised funds and to review the wording of the fund objectives as well as the disclosure and use of benchmarks.

Value assessment

The value assessment must be done for each fund based on specific criteria that have been prescribed by the FCA such as price, performance, economies of scale and quality of service. This exercise is to be carried out by the fund’s board, the composition of which must include at least two independent members. At the end of the process, a summary needs to be publicly disclosed that discusses the conclusion of the exercise for each and what measures have been or will be taken to address cases where there is no value for money. The requirements for the value assessment and the existence of independent directors have been effective since the end of September 2019.

There is nothing equivalent on an EU level but the content of the discussions, particularly around ESMA’s work on costs and performance is very similar to the narrative used by the FCA.

Use of benchmarks

In parallel, the FCA introduced remedies that aimed to make it clearer to investors (and particularly retail investors) what a fund is trying to achieve and then how it has delivered against this objective. The FCA chose to introduce guidance for the wording of fund objectives but imposed rules for the disclosure of performance and use of benchmarks. For this purpose, it defined three types of benchmarks: ‘target’, ‘constraining’ and ‘comparator’ and required that where a fund uses target or constraining benchmarks, it should disclose performance against both.

The new rules have been effective since May 2019 for new funds and August 2019 for existing funds. There are strong parallels to ESMA’s work, and particularly with the amendments in the Q&A for UCITS and AIFs. ESMA did not use the same benchmark definitions but it is clear that the thinking was similar.

This can be seen in the similar description of the comparator benchmark in ESMA’s Q&As and the constraining benchmark in the FCA’s rules.

Pension freedoms and retirement outcomes

In parallel to the asset management market study, the FCA carried out an extensive review on the actions that non-advised consumers have taken following the pension freedoms introduced in 2015, that allowed retirees full flexibility in terms of how they use their retirement savings. This is known as the Retirement Outcomes Review which was concluded in June 2018 and which found that there are weak competitive pressures, low levels of switching, and that some providers were ‘defaulting’ customers into cash. The FCA has proposed and consulted on several measures. Policy Statements 19/1 and 19/21 set out new rules and guidance that:

- Require providers to send various information to consumers before they decide how to access their pension savings, such as ‘wake-up’ packs, risk warnings and information on annuities
- Require providers to offer non-advised customers ready-made ‘investment pathways’
- Ensure customers that access drawdown, invest mainly in cash only if they have taken an active decision to do so
- Require providers to send annual information to consumers who have accessed their pensions on all costs and charges paid over the previous year

Although precise timelines have not been specified at the time of writing, it is expected that these requirements will apply from late 2020.

Additionally, the FCA consulted on extending the remit of Independent Governance Committees to cover value for money assessments for investment pathways. The final rules are expected in Q4 2019.

Conduct

Senior Managers and Certification Regime (SMCR)

The SMCR is a regulatory framework aiming to increase individual accountability within firms and, by extension, reduce harm to consumers and strengthen market integrity. At a high level, it identifies a number of ‘prescribed responsibilities’ and assigns these to senior executives within a firm, who are the ‘senior managers’ accountable for their conduct and competence in managing these responsibilities. A degree of flexibility is allowed for firms.

SMCR replaced the Approved Persons Regime in the UK and applied first to banks in 2016 and then in December 2019 will be extended to all solo regulated firms overseen by the Prudential Regulatory Authority (PRA) and the FCA. Notably, the SMCR includes a prescribed responsibility for the fund board’s value assessments, independent director representation and acting in investors’ best interests. This will sit with the fund board’s chair who will be personally accountable for the robustness and completion of the value assessment exercise.

FCA focus on culture

Firms’ culture and governance is a cross sector priority for the FCA over the course of 2019/20 as identified in its Business Plan. This includes:

- Exploring the role of purpose and the linkage between healthy cultures and outcomes for consumers, markets and firms
- Reviewing firms’ remuneration practices through the FCA’s supervisory activities
- Extending of SMCR to all firms

It remains unclear whether this will translate into any specific course of action or regulatory intervention but it signals a desire by the UK regulator to see how firms behave beyond the rules.

Gender pay gap reporting

An issue that is increasingly being debated in the UK is diversity and specifically gender diversity, women’s representation in senior positions and the gender pay gap. This has been brought to the fore since the introduction of new rules in April 2017 requiring all firms with more than 250 employees to publish on an annual basis:

- Gender pay gap (mean and median averages)
- Gender bonus gap (mean and median averages)
- Proportion of men and women receiving bonuses
- Proportion of men and women in each quartile of the organisation’s pay structure
These rules apply to asset managers as well and the emerging figures indicate that gender pay gap (31%) is higher than the financial services overall median (28%) that itself is much higher than the overall UK median (18%)\(^2\).

There are broader initiatives to promote gender diversity in financial services such as the Women in Finance Charter. This is currently voluntary but there features within this such as setting targets for diversity and linking executive pay to the delivery against these targets that require specific actions from signatories.

**Sustainable investment**

**Revised stewardship framework**

The stewardship framework within which asset managers in the UK operate has been largely determined by the Financial Reporting Council’s (FRC) Stewardship Code. The Code has a number of principles and asset managers in the UK that sign up to it can comply with the principles or explain why they have not done so. The Code has been in place since 2012 but currently the entire framework is being overhauled following a number of consultations throughout 2019 including proposed revisions to the Stewardship Code itself, an FCA consultation on the implementation of the Shareholder Rights Directive, and an independent review of the FRC.

The FRC published its revised Code in October 2019, which will come into effect in January 2020, placing a new emphasis on stewardship outcomes. Specifically, the new Code has:

- An extended focus that includes asset owners, such as pension funds and insurance companies, and service providers as well as asset managers
- A requirement to report annually on stewardship activity, showing what has actually been done in the previous year and what the outcome was, including engagement, voting records and how investment value have been maintained and enhanced
- A requirement for signatories to explain how they have exercised stewardship across asset classes beyond listed equity, such as fixed income, private equity and infrastructure, and in investments outside the UK
- A requirement for signatories to explain their organisation’s purpose, investment beliefs, strategy and culture and how these enable them to practice stewardship, including details around resourcing and staff incentives

At the same time the FCA issued a feedback statement on the regulatory framework for stewardship, noting that the FCA does not plan to impose additional regulations around stewardship, but will carefully monitor implementation of the revised Stewardship Code and SRD II. Nevertheless, the FCA has identified some barriers to effective stewardship that it will seek to address, including:

- Investment mandates between asset owners and asset managers that may not be fully aligned with stewardship objectives
- Potentially inadequate climate change disclosure by issuers
- Regulatory uncertainties in MAR and competition law that may discourage engagement between issuers and investors
- Stewardship disclosure that may not be detailed enough for investors to distinguish between firms
- Service providers such as proxy advisors and investment consultants may not adequately support stewardship

The combined outcome of the revised Code, implementation of SRD II, and any FCA actions to address the above points, will set the tone for how asset managers in the UK exercise and disclose their stewardship responsibilities. Sustainability, purpose and outcomes are going to be the key themes.

**Green Finance strategy**

The UK government unveiled its Green Finance strategy in July 2019, outlining a series of actions to transform financial services by ensuring climate and environmental factors are fully integrated into mainstream financial decision making across all sectors and asset classes. Specifically, the main objectives are:

- Aligning private sector financial flows with clean, environmentally sustainable and resilient growth
- Strengthening the competitiveness of the UK financial services sector

The strategy to achieve this is going to follow a threefold approach:

1. ‘Greening finance’, that is about taking into account financial material environmental risks
2. ‘Financing green’, which involves financing investments that contribute positive solutions to environmental problems
3. ‘Capturing the opportunity’ which is about ensuring UK financial services capture the domestic and international commercial opportunities arising from the ‘greening of finance’, such as climate related data and analytics, and from ‘financing green’, such as new green financial products and services

The strategy acknowledged the EU’s Sustainable Finance Action Plan and noted that the Government will aim to match the ambition of the Action Plan’s objectives and will continue to support the EU’s work in this area.

**Financial stability**

**Bank of England (BoE)**

Financial stability is a main responsibility for the BoE which carries out regular reviews of the banking sector as well as financial services more broadly through two statutory bodies. Its Financial Policy Committee (FPC) publishes a Financial Stability Report twice a year setting out the FPC’s outlook for UK financial stability, including its assessment of the resilience of the UK financial system and the current main risks to financial stability. The latest report in July 2019 commented on a number of issues, such as Brexit, and specifically for open-ended funds, identified three areas of potential concern:

- Investments in emerging equity and debt that may turn illiquid under stressed market conditions
- Increasing holdings of leveraged loans so that now pension funds, insurers and investment funds hold around 40% of the total global leveraged loan market
- Increased holdings of collateralised loan obligations (although banks remain the dominant holders)

According to the FPC, these may culminate in a potential mismatch between redemption terms and fund liquidity. Hence, the BoE and the FCA will carry out a review to examine the costs and benefits of aligning redemption terms with the typical time it takes to realise market prices for funds’ assets in normal and stressed market conditions. They will also examine the effectiveness of measures that are already used to deal with misalignment of redemption terms and asset liquidity, such as swing and fair value pricing and suspensions.

\(^2\) The Investment Association, *Closing the gap: addressing the gender pay gap*, March 2019
Illiquid assets in open-ended funds

The use of illiquid assets in open-ended funds and the availability of an effective liquidity risk management toolkit has been a focal area for the UK regulator particularly since the temporary suspension of redemptions for some property funds following the UK referendum result to exit the EU in 2016. In October 2018, the FCA issued a consultation paper looking at changes in the liquidity risk management framework for open-ended funds and particularly those that are not subject to UCITS rules but are available to retail clients. The final guidance and rules were published in a policy statement almost a year later, in September 2019, the delay apparently being caused by the suspension in dealing of a high profile fund23. The policy statement unveiled a new type of fund called ‘fund investing in inherently illiquid assets’ (FIIA) that will be subject to stringent requirements, such as enhanced depositary oversight, increased disclosure of risk management tools and liquidity risk contingency plans.

Furthermore, the new rules supplemented existing guidance in three ways:

- Disclosure – the fund manager needs to explain the liquidity profile of any fund and the associated risks of funds that invest in less liquid assets in client-facing documents. Arrangements for any suspension of dealing should be made clear in the fund’s prospectus

- Suspension – non-UCITS funds must suspend where the standing independent valuer expresses material uncertainty over the value of 20% of the fund assets. The fund manager may continue to deal in some exceptional circumstances, as long as this is in agreement with the depositary and concerns the investors’ best interests

- Liquidity risk management – managers of FIIs must produce contingency plans for dealing with liquidity risk. Additionally, depositaries will have a specific duty to oversee the processes used to manage fund liquidity

The new guidance and rules will come into force on 30 September 2020.

23 Contrary to the Brexit referendum in 2016, this case involved practices around a single fund that pointed to gaps in governance and oversight rather than liquidity risk management.
Appendix 2: Regulatory developments in the United States

Consumer protection

Client Best Interest Rule

In June 2019, the Securities and Exchange Commission (SEC) adopted a package of new rules, amendments and interpretations to enhance the quality of retail investors’ relationships with broker-dealers and investment advisers (asset managers). The rulemaking package is designed to enhance investor protections while preserving retail investor access and choice in the type of professional with whom they work, the services they receive, and how they pay for these services.

Regardless of whether a retail investor chooses a broker-dealer or an investment adviser (or both), the retail investor will be entitled to a recommendation (from a broker-dealer) or advice (from an investment adviser) that is in the best interest of the retail investor and that does not place the interests of the firm or the financial professional ahead of the interests of the retail investor.

By 30 June 2020, registered broker-dealers must begin complying with the Regulation BI and broker-dealers and investment advisers will be required to prepare a relationship summary that they deliver to retail investors and file with the SEC.

Interestingly, in September 2019, the Attorneys General of New York, California, Delaware, Maine, New Mexico, Oregon, and the District of Columbia jointly filed suit in the Southern District of New York against the SEC, arguing that ‘Regulation Best Interest’ fails to meet basic investor protections set out in the Dodd-Frank Act. They argue that the regulation does not meaningfully elevate broker dealer standards beyond their existing suitability requirements and that it is unlikely to reduce investor and industry confusion as it relies on a ‘best interest’ standards and key terms that are undefined.

Frequently Asked Questions (FAQs) regarding the disclosure of financial conflicts

The Division of Investment Management at the SEC issued in October 2019 FAQs on conflicts of interest that investment advisers may have and how these are managed and disclosed to clients. The FAQs do not amend the regulation but they highlight what regulatory expectations are in this area. Specifically, the SEC highlights that in the process of supervision there have been cases where investment advisers have not appropriately addressed conflicts of interest where their compensation is connected to the investments they recommend and related services they provide. Points that are stressed in the FAQs include:

- Disclosing to clients where compensation is connected to a specific recommendation, providing sufficiently specific facts so that clients understand the nature of the conflict
- Disclosing business activities of any of the adviser’s supervised persons where they receive money connected to the adviser’s recommendation
- Disclosing how the conflict is addressed

Modernisation of advertising rules

In November 2019, the SEC proposed amendments to modernise the advertising rule 206(4)-1 in the Investment Advisers Act 1940 given the significant evolution of market practices since the rule’s adoption in 1961, such as increasing use of technology for communications. This is part of broader proposals that also aim to modernise cash solicitation rules and amend Form ADV which is designed to provide the SEC with information regarding advisers’ advertising practices.

There is a 60-day window for interested parties to comment on these proposals.

The SEC is taking a principles-based approach for the advertising rule. It proposes that the definition of ‘advertisement’ is updated to remain flexible enough in face of technological advances and industry practices. It makes concrete proposals on the communication of performance to retail investors, including:

- Prohibiting disclosure of gross performance if the fees and expenses or net performance are not presented
- Prohibiting statements that the calculation or presentation of performance has been approved or reviewed by the SEC
- Requiring presentation of net performance over one-, five- and 10-year periods

Last but not least, any advertisement would need to be reviewed and approved in writing by a ‘designated employee’.

MiFID II Research Exemption

The introduction of the MiFID II requirement to unbundle research from commission posed a significant challenge for the US market. That was because US rules allow a broker to sell research for ‘soft dollars’, i.e. as an indirect payment through commission, but not for ‘hard dollars’ unless the broker is also registered as an investment adviser. So from January 2018 US institutions with only broker-dealer registrations would not have been able to provide research to EU asset managers that had elected to pay ‘hard dollars’ to obtain research.

To address this, in October 2017, the SEC granted no-action relief which enabled investment advisers to pay US brokers ‘hard dollars’ for research. This relief was set to expire in July 2020 but, in November 2019, the SEC extended the relief for an additional three years. This decision came after extensive engagement that the SEC had with various stakeholders, such as broker dealers and asset managers, to better understand market practices after the implementation of MiFID II.

According to the SEC some challenges remain in identifying MiFID II effects on the market for research and the additional time will allow to evaluate whether further guidance or regulatory action is needed.

It is worth noting that at the same time a bill is being discussed to ‘require the Securities and Exchange Commission to carry out a study to evaluate the issues affecting the provision of and reliance upon investment research into small issuers’. Further developments are expected in 2020.

Conduct

Data protection

The introduction of GDPR in the EU has had one unintentional consequence for EU-based asset managers that have applied to register with the SEC in the US\(^\text{20}\). As GDPR gives individuals greater control over their data, the US regulator requires access to that data, including financial statements and trade records, as part of its broader remit to protect investors. This has resulted in a number of EU-based applications not gaining approval by the SEC and being placed on hold instead. This remains unresolved.

At the same time, there are new rules in the US aiming to enhance data protection. The California Consumer Privacy Act (CCPA) of 2018 is similar to GDPR and aims to protect individuals’ personal data. The Act takes effect in July 2020 and the main intentions are to provide California residents with the right to:

- Know what personal data is being collected about them
- Know whether their personal data is sold or disclosed and to whom
- Opt out of the sale of their personal data
- Enjoy equal service and price, even if they exercise their privacy rights

The CCPA gives individuals and state attorneys the right to pursue legal action if any breaches of the law are suspected. Importantly, the CCPA does provide significant carve-outs for information obtained pursuant to a relationship governed by the Gramm Leach Billey Act. As a result, while investment advisers are still affected by the CCPA, the regulatory burdens imposed on investment advisers are not as extensive as will be the case for a number of other types of businesses.

Sustainable investment

Proxy advice

Although not directly targeted at investment managers, the SEC has recently changed guidance and issued proposals for amending rules that may significantly change the way proxy voting service providers operate and, as a result, the framework within which investment advisers in the US exercise their voting rights.

Initially, the SEC issued two sets of guidance regarding the proxy voting process. The first guidance regarded the proxy voting responsibilities of investment advisers and stressed their fiduciary duty and duties of care and loyalty towards their clients when voting. It contained several points that investment advisers need to do when using proxy voting firms such as assessing whether the proxy voting firm is capable of adequately analysing relevant material and has effective processes in place to seek timely input from issuers.

The second guidance interpreted proxy voting advice as ‘solicitation’, which according to the Securities Exchange Act Rule 14a-9, prohibits false or misleading statements or omissions. The SEC noted that proxy advisory firms should consider adding in the voting advice details of the methodology used, disclose use of external sources of information and whether these differ from the proxy adviser’s public disclosures, and disclose and material conflicts of interest.

This was then followed by proposals to codify SEC’s interpretation that proxy voting advice generally constitutes a solicitation and amend the Securities Exchange Act Rule 14a-2(b) to outline under what conditions proxy advisers could be exempt from quite burdensome filing and information requirements25. These conditions require that proxy advisers:

- Include disclosure of material conflicts of interest in their proxy voting advice
- Give issuers the opportunity to review and provide feedback on proxy voting advice before it is issued
- Give issuers the right to request that a link is added to the advice, directing the recipient of that advice to a written statement about the issuer’s view on the advice

If adopted, these proposals would effectively open the door for litigation against proxy advisers where any third party considers the advice or the underlying methodology to be misleading or inaccurate. They would also require proxy advisers to share their advice with corporate managers before they provide it to investors. This may have a significant effect where votes are controversial and it has prompted a prominent proxy adviser, Institutional Shareholder Services, to pursue legal action against the SEC26.

Shareholder proposals

In the context of the broader proxy voting reform, the SEC has also published proposed amendments to the Securities Exchange Act Rule 14a-8 that provides the framework for the submission of shareholder proposals to be included in a company’s proxy statement. These proposals would raise the bar for shareholders who wish to submit proposals in several ways:

- The current threshold of holding at least $2,000 of the company’s securities for at least one year may rise to: $2,000 for at least three years; $15,000 for at least two years; or $25,000 for at least one year
- Each shareholder submitting a proposal must be able to meet with the company no less than 10 calendar days and not more than 30 calendar days and provide contact information and times for this meeting
- A shareholder can submit only one proposal at each meeting.
- The thresholds for resubmitting a proposal would increase from 3%, 6% and 10% for matters voted on once, twice, three or more times in the last five years to 5%, 15% and 25%
- Companies would be allowed to exclude proposals under certain circumstances where shareholder support for the matter has declined

The SEC is inviting comments on these proposals until early January 2020.

Capital markets

Allocation of Investment Opportunities (Treating Customers Fairly)

Bunching customer orders into larger block trades and allocating the executed order into multiple customer accounts is a common practice for investment advisers. However, regulators often find unscrupulous acts of allocating winning trades to favoured accounts and vice versa. The practice commonly referred to as ‘cherry picking’ was a recurring theme in the past year with regulatory actions at the Commodity Futures Trading Commission and the SEC.

Modernisation of exchange-traded fund (ETF) regulation

In September 2019, the SEC voted to adopt the new 6c-11 rule under the 1940 Investment Company Act that amends the registration and relevant disclosure requirements for ETFs. This aims at modernising the regulation of ETFs and is part of the SEC’s broader objective to establish a regulatory framework that ensures a level-playing field between ETFs and other open-ended fund structures.

In the main, this new framework removes an obligation for active and passive ETFs to first obtain an individual exemptive order in order to register as an open-end investment company with the SEC (the exemptive order remains in place for inverse and leveraged ETFs, ETFs that are closed-ended, and ETFs structured as a share class of a multi-class fund). This will in turn enable new ETFs to come to market more quickly than was previously the case. In order to take advantage of the rule, the ETF must meet certain conditions, including:

- Disclosing daily on the ETF’s website the portfolio holdings that form the basis for the calculation of the net asset value per share
- Disclosing historical information on the net asset value per share, market price, premiums, discounts and bid-ask spreads
- Detailed recordkeeping for all authorised participant agreements
- Adopting and implementing policies and procedures for the construction of custom baskets that are in the best interests of the ETF and its shareholders

The rule will be effective 60 days after the publication in the Federal Register and the relevant ETF exemptive orders that had been granted previously, will be rescinded a year after the effective date.
Financial stability

SEC liquidity rules

In October 2016, the SEC adopted the new rule 22e-4 reforming the regulatory framework for liquidity risk management of funds. The application of the rule was subject to delays that the SEC attributed to challenges relating to interpretive guidance, service providers, and system readiness and finally the main aspects of it became effective in December 2018 for funds with over $1 billion in assets and June 2019 for smaller funds.

Effectively, the 22e-4 rule requires that each fund adopts a liquidity risk management programme that incorporates:

- Assessment, management and review of liquidity risk considering the fund’s investment strategy, the liquidity of the portfolio holdings and cash-flow projections under normal and stressed conditions and holding of cash or cash equivalents
- Responsibilities for the fund’s Board to oversee and regularly review the liquidity programme as well as approve the staff with responsibility for administering it
- Classification on liquidity of each holding in buckets (highly liquid, moderate liquid, less liquid, illiquid) based on the number of days that can be reasonably expected to convert the holding to cash without significantly reducing the holdings’ value
- Determination and review of the ‘highly liquid investment minimum’ (HLIM) that will also be part of the Board’s oversight
- Limiting the proportion of the illiquid bucket to no more than 15% of fund net assets

There are further requirements around the public disclosure of a portfolio’s liquidity and (non-public) reporting of more granular data to the SEC.

The challenges that have arisen during the development of this rule (and, to a certain extent remain) are around the heavy reliance on service providers for data provision and assignment of holdings to buckets and the non-comparability of the ensuing figures given the difference in approach that each service provider takes.27

27 For further details, see the Investment Company Institute’s evidence and comment letters to the SEC.
### Appendix 3: Glossary

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>AIF</td>
<td>Alternative Investment Fund</td>
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<td>AIFMD</td>
<td>Alternative Investment Fund Managers Directive</td>
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<td>AMLD</td>
<td>Anti-Money Laundering Directive</td>
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<tr>
<td>BEPS</td>
<td>Base Erosion and Profit Shifting</td>
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<tr>
<td>BIS</td>
<td>Bank of International Settlements</td>
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<td>BoE</td>
<td>Bank of England</td>
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<td>CCP</td>
<td>Central Counterparty</td>
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<td>CCPA</td>
<td>California Consumer Privacy Act</td>
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<td>CMU</td>
<td>Capital Markets Union</td>
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<td>CRD</td>
<td>Capital Requirements Directive</td>
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<tr>
<td>CRR</td>
<td>Capital Requirements Regulation</td>
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<tr>
<td>EBA</td>
<td>European Banking Authority</td>
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<tr>
<td>EIOPA</td>
<td>European Insurance and Occupational Pensions Authority</td>
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<tr>
<td>EMIR</td>
<td>European Market Infrastructure Regulation</td>
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<tr>
<td>ESAs</td>
<td>European Supervisory Authorities (ESMA, EIOPA and EBA)</td>
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<tr>
<td>ESFS</td>
<td>European System of Financial Supervision</td>
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<tr>
<td>ESG</td>
<td>Environmental, Social and Governance</td>
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<tr>
<td>ESFS</td>
<td>European System of Financial Supervision</td>
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<td>ESMA</td>
<td>European Securities and Markets Authority</td>
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<td>ESRB</td>
<td>European Systemic Risk Board</td>
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<tr>
<td>ETF</td>
<td>Exchange-Traded Fund</td>
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<td>EU</td>
<td>European Union</td>
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<tr>
<td>FCA</td>
<td>Financial Conduct Authority</td>
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<tr>
<td>FIIFA</td>
<td>Fund Investing in Inherently Illiquid Assets</td>
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<td>FRC</td>
<td>Financial Reporting Council</td>
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<td>FSB</td>
<td>Financial Stability Board</td>
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<td>FSP</td>
<td>Financial Policy Committee (Bank of England)</td>
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<td>FTT</td>
<td>Financial Transactions Tax</td>
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<td>GDPR</td>
<td>General Data Protection Regulation</td>
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<td>IBOR</td>
<td>Interbank Offered Rate</td>
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<td>IDD</td>
<td>Insurance Distribution Directive</td>
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<td>IFD</td>
<td>Investment Firms Directive</td>
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<td>IFR</td>
<td>Investment Firms Regulation</td>
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<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
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<td>JRC</td>
<td>Joint Research Centre</td>
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<tr>
<td>KID</td>
<td>Key Information Document (PRIIP)</td>
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<td>KIID</td>
<td>Key Investor Information Document (KIID)</td>
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<td>LIBOR</td>
<td>London Interbank Offered Rate</td>
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<td>MAD</td>
<td>Market Abuse Directive</td>
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<td>MAR</td>
<td>Market Abuse Regulation</td>
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<td>MiFID</td>
<td>Markets in Financial Instruments Directive</td>
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<td>NFC</td>
<td>Non-financial Counterparties</td>
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<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>OTC</td>
<td>Over-the-counter</td>
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<td>PEPP</td>
<td>Pan-European Personal Pension</td>
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<td>PRA</td>
<td>Prudential Regulatory Authority</td>
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<td>PRIIP</td>
<td>Packaged Retail and Insurance-based Investment Products</td>
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<td>RIY</td>
<td>Reduction-in-yield</td>
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<td>SEC</td>
<td>Securities and Exchange Commission</td>
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<td>SFT</td>
<td>Securities Financing Transaction</td>
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<td>SFTR</td>
<td>Securities Financing Transaction Regulation</td>
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<td>SMCR</td>
<td>Senior Managers and Certification Regime</td>
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<tr>
<td>SMEs</td>
<td>Small and Medium-Sized Enterprises</td>
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<td>SRD</td>
<td>Shareholder Rights Directive</td>
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<tr>
<td>TEG</td>
<td>Technical Expert Group</td>
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<tr>
<td>TRS</td>
<td>Total Return Swap</td>
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<tr>
<td>UCITS</td>
<td>Undertakings for the Collective Investment in Transferable Securities</td>
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<tr>
<td>VAT</td>
<td>Value-added Tax</td>
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</tbody>
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28 For several files there is both a ‘Regulation’ and a ‘Directive’, such as IFR/IFD, MAR/ MAD. ‘Regulation’ is an EU rule that apply directly to all entities in the EU. ‘Directive’ is regulation that is transposed into national law in each Member State. Hence, a ‘directive’ allows more flexibility in the implementation whereas a ‘regulation’ is more appropriate when it is important for policymakers to harmonise the application of regulation across the EU.

29 See Footnote 7 for further details.
Important Information

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