Regulations to watch in 2019:
Global Investment Funds
As part of a series of insight papers exploring the impact of regulation on its core client base, HSBC Securities Services takes a look at what lies in store for the global investment funds’ industry in 2019. In a world being reinvented by disruption and transformation, clients have been confronted with a number of significant regulatory changes over the last year.

While some of these rules are introducing additional costs and barriers to the buy-side industry, other reforms – such as improvements to existing regulations and the roll-out of new cross-border passporting initiatives - have received a warmer reception from market participants. Nonetheless, the next 12 months could pose a number of challenges for asset managers and asset owners, as a new crop of regulations and market changes take hold.

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Europe: The regulation keeps flowing

AIFMD: More to come in 2019

In January 2019, the European Commission (EC) published the findings of a survey conducted by KPMG assessing the status and progress made by the Alternative Investment Fund Managers Directive (AIFMD). The report said that while AIFMD had created a harmonised regulatory framework for AIFMs (alternative investment fund managers), half of the respondents said the rules were applied inconsistently across EU member states.

Key criticisms included member states levying additional authorisation requirements onto sub-threshold AIFMs, “insufficient” and “duplicitous” reporting obligations, unevenness in depositaries’ approaches towards look-throughs and cash flow monitoring in different jurisdictions, unnecessary asset segregation provisions and an absence of standardisation between AIFMD and UCITS’ leverage calculation methodologies.

As a result, the EC may push through further AIFMD reforms based on the concerns raised in this consultation.

Distributing in Europe in 2019

The EC is also trying to rationalise AIFMD registration and authorisation processes across the EU in an attempt to reduce cross-border distribution activity as part of the Capital Markets Union (CMU). However, the EC has also proposed tougher requirements for unregistered managers looking to reach out to prospective investors by tightening the rules on pre-marketing.

In June 2018, Europe’s Council of Ministers announced its own reverse solicitation proposals, which are viewed in some quarters as being more palatable than the recommendations put forward by the EC. Managers will therefore be eagerly awaiting comments from the European Parliament on this matter.

Despite efforts to standardise European distribution processes, the process of selling and buying fund units cross-border is likely to become more complicated as a consequence of geopolitics. The UK Financial Conduct Authority (FCA) has created a temporary permissions regime (TPR) which “will allow EEA firms and funds to continue regulated business in the UK, if the UK leaves the EU in March 2019 without an implementation period in place.”

Under this arrangement, EU UCITS and alternative investment funds (AIFs) will be permitted to market into the UK for a limited period. This reprieve is conditional on those managers notifying the FCA by March 28, 2019 about which products they intend to distribute inside the UK. A failure to submit the proper notifications to the FCA will result in that EEA manager being unable to leverage the TPR and “they will not be able to continue marketing that fund in the UK on the same basis as they did before exit day.”

The UK’s TPR has, however, not been reciprocated by the EU authorities, who have simply “issued statements concerning the need for UK institutions to submit their application for authorisation in the relevant member state before the end of Q2 2018.” UK firms are currently analysing whether to apply ESG (environment, social, governance) due diligence in line with the ESMA’s intentions. A number of buy-side groups have argued ESMA’s positioning on delegation risks undermining local EU regulators in ManCo hubs such as Luxembourg and Dublin, for example, while adding inefficiencies to the existing process.

Going green in Europe

In 2018, the EC announced its Action Plan on Sustainable Finance, the provisions of which are likely to require asset managers to apply ESG (environment, social, governance) criteria to some of their investment processes. Amid concern that certain institutions are misrepresenting their ESG track records, the EC has said it will force firms to disclose details about their ESG policies to clients. In order to make it easier for investors to compare different managers’ ESG practices, the EC is establishing a standardised ESG taxonomy.

Initially, there were fears these proposals would prove difficult for the buy-side, as many firms believed adopting an excessively systematised ESG approach might restrict their investment strategies. ESMA has since elaborated that the rules on integrating sustainability risk assessments into the UCITS and AIFMD frameworks will not be prescriptive but principles-based to give the industry more flexibility on the matter.

Global investment funds should therefore be assessing how they consider sustainability risks in their core risk management and due diligence in line with the ESMA proposals. This policy recommendation could prompt some managers to overhaul their internal procedures, systems and controls during 2019 to pre-empt any upcoming regulations.

The End of LIBOR

One of the most significant recent policy initiatives has been the phasing out of LIBOR by UK and global regulators following a series of rate rigging scandals and a general decline in unsecured lending by participants in the interbank market.

With approximately $350 trillion of contracts using LIBOR as a benchmark rate, the transition will have a major impact on asset managers’ business activities and the underlying products in their portfolios.

Aggressive tax planning: Nowhere to hide

Capping off what is turning out to be an increasingly productive year for European regulators is DAC 6 (Directive on Administrative Cooperation 6), a requirement demanding intermediaries disclose to the relevant authorities any aggressive tax planning arrangements being perpetrated by clients. These rules are likely to be transposed into national laws on an EU-wide basis at the end of 2019.

Regulation of Management Companies

European regulators are also taking a deeper interest in fund manager substance, as the authorities become increasingly concerned about the risk of letterbox entities taking hold inside the EU. While the practice of delegation - whereby an EU domiciled management company (ManCo) outsources portfolio management to a third country investment adviser is unlikely to be prohibited, the European Securities and Markets Authority (ESMA) has made clear that it will be taking a greater interest in some of these arrangements.

Industry experts recognise there needs to be some sort of EU-wide consistency and standardisation in terms of the bloc’s interpretation and application of substance, but there is growing scepticism about ESMA’s intentions. A number of buy-side groups have argued ESMA’s positioning on delegation risks undermining local EU regulators in ManCo hubs such as Luxembourg and Dublin, for example, while adding inefficiencies to the existing process.

Global Custodian (January 3, 2019) Change of ESG approach by ESMA welcomed by asset managers

PwC (March 13, 2018) EU Direct Tax News Alert

15 Deloitte (October 10, 2018) Oversight of delegation in fund management: what are regulators focused on?
16 FCA (May 24, 2018) Sustainable finance: Making the financial sector a powerful actor in fighting climate change
17 ESMA (December 10, 2018) Consulting paper: On integrating sustainability risks and factors in the UCITS Directive and AIFMD
18 Deloitte (October 10, 2018) Oversight of delegation in fund management: what are regulators focused on?
19 PwC (July 12, 2018) Interest rate benchmark reform: Transition to a world without LIBOR
20 EC (January 7, 2019) Notification window for the temporary permissions regime now open
21 Norton Rose Fullbright (August 2018) Brexit and the UK temporary permissions regime – what we know so far
22 EC (October 10, 2018) CP18/29: Temporary permissions regime for inbound firms and funds
23 FCA (January 9, 2018) Temporary permissions regime for insubordinate firms now open
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36 EC (October 10, 2018) Proposal to clarify pre-marketing under AIFMD
Middle East: More reforms to come in 2019

Market-wide diversification
MENA countries – after many years of reliance on oil revenues – are looking to diversify their economies by attracting more foreign investment into their markets. Post-trade reforms in Kuwait, the UAE, Oman, Qatar, Bahrain and Egypt have been in progress for several years now, but it is the initiatives underway in Saudi Arabia which have generated the most client interest, on account of its deep liquidity pool and market capitalisation size.

Insolvency reform
Equally encouraging is that insolvency laws across MENA are being strengthened in what should help shore up foreign investment. Both Saudi Arabia and Bahrain are implementing bankruptcy laws based on international standards such as Chapter 11,23 which will offer better protection to creditors and stricken companies.24 These changes are bringing MENA markets into line with globally accepted standards on investing.

Index inclusion
These liberalising measures have been acknowledged by index providers, with MSCI announcing in 2018 that Saudi Arabia would be incorporated onto its Emerging Markets Index in 2019,25 a development which could result in $35 billion of passive and active flows heading towards the country.26 In addition, FTSE Russell indicated it will upgrade Saudi Arabia onto its emerging market index from March 2019.27

Reforms in Kuwait have paid off as well with FTSE Russell assimilating the Gulf country onto its secondary emerging market index in 2018,28 while MSCI simultaneously said it would review its status in a potential prelude to an upgrade.29 These upgrades are likely to lead to more institutional flows from passive and active managers moving into the region in 2019 thereby enhancing liquidity across the GCC.

Development of an investor base in the GCC
Of the $3.5 trillion in investable assets within the GCC, $2.9 trillion is derived from sovereign wealth funds (SWFs), while just $411 billion is managed on behalf of pension funds.30 Efforts – albeit quite slowly - are being made by a handful of governments to encourage people to save more of their wealth to offset some of the longer-term risks (i.e. oil price declines) facing these countries.31 This policy change could result in a growing movement away from defined benefit (DB) pension schemes to defined contribution (DC) structures.

The pivot towards DC could be beneficial for global investment firms looking to diversify their investor pools beyond their existing markets.32 Despite the abundance of investable assets in the GCC, cross-border fund distribution continues to be a convoluted process as a result of arbitrages in local regulations. Consequently, it is improbable that a GCC funds’ passport modelled on the UCITS or AIFMD templates is going to materialise anytime soon.33

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**APAC: Better distribution, better products**

**ARFP: The APAC UCITS?**

The Asia Region Funds Passport (ARFP), a cross-border product distribution scheme covering Australia, Japan, Korea, New Zealand and Thailand, will launch in February 2019 although many within the industry are adopting a wait and see policy towards the initiative. History has shown that developing fully-fledged fund passporting schemes is tough work, evidenced by the relatively muted response to the ASEAN Collective Investment Scheme (covering Singapore, Malaysia and Thailand) where only six funds have been authorised since 2014.

While both schemes could potentially test the hegemony of UCITS and other offshore funds in the region, it is unlikely to happen in the short term due to a number of cross-border barriers, regulatory arbitrages and operational obstacles. The biggest problem is that distribution in APAC is fragmented as are the fund authorisation processes and their time-lines. For a regional passporting scheme to mature and accumulate cross-border assets, there also needs to be harmonisation of individual markets’ tax treatment for foreign funds.

**MRF: Moving out of Asia**

Notwithstanding, the low volumes and limited number of fund authorisations so far on the Hong Kong-China leg of MRF (Mutual Recognition of Funds), the scheme’s architects have further extended the programme to Switzerland, France, the UK and most recently Luxembourg, which signed a memorandum of understanding on MRF in early 2019. Policymakers will be keen to understand the rate of adoption of MRF by European asset managers. Of course, many of these firms already distribute into the region using existing and existing to their existing, well established trust vehicles.

Hong Kong’s Fund governance is being shaken up in APAC too, in effect replicating some of the work being done by the UK’s FCA. The Hong Kong Securities and Futures Commission (SFC), for example, launched its Fund Manager Code of Conduct (FMCC) in 2018. The FMCC outlines asset managers’ responsibilities and demands firms adopt market misconduct and risk management policies and procedures, deliver enhanced investor disclosures, and exercise due skill, care and diligence during the selection and ongoing monitoring of their custodians.

Hong Kong’s Unit Trust Code is also getting an investor protection revamp which bears a passing resemblance to some of the provisions contained in the EU’s UCITS V in what should further enhance the jurisdiction’s international standing.

**WFOE: A way to attract mainland clients**

China has also opened up newer avenues for managers to access its investor market. In 2017, China established the WFOE (Wholly Foreign-Owned Enterprise) which allows international asset managers to target mainland institutions without having to enter into a minority interest joint venture with a local onshore company. There are currently 15 global asset managers with a PFM (private fund management) license using the WFOE.

**New APAC fund structures come to market**

APAC policymakers are striving to position their markets as asset management hubs. Hong Kong, Singapore and Australia have all launched corporate fund structures, providing an alternative to their existing, well established trust vehicles.

**Governance reform**

Fund governance is being shaken up in APAC too, in effect mirroring some of the work being done by the UK’s FCA. The Hong Kong Securities and Futures Commission (SFC), for example, launched its Fund Manager Code of Conduct (FMCC) in 2018. The FMCC outlines asset managers’ responsibilities and demands firms adopt market misconduct and risk management policies and procedures, deliver enhanced investor disclosures, and exercise due skill, care and diligence during the selection and ongoing monitoring of their custodians.

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Meanwhile, the Monetary Authority of Singapore (MAS) is pushing through with its own initiatives by raising the bar for individual accountability at managers and consulting on provisions to improve liquidity risk management practices. It is expected these developments will gain traction in 2019.

**Looking towards a greener future**

ESG adoption in Asia has traditionally lagged behind that of Europe and North America, evidenced by the fact that of the 2,205 UN PRI (Principles for Responsible Investment) signatories, just 318 are located in APAC. However, attitudes are changing, with a number of regional asset owners – including the $21 billion Government Pension Fund (GPF) in Thailand, Malaysia’s public services pension fund KWP, South Korea’s National Pension Service and New Zealand’s Victoria University Foundation all signing up to the UN PRI.

While the UN PRI is a voluntarily regime, local regulators are beginning to implement their own ESG frameworks. Responsible investment is gaining ground in China after a slow start. With a slew of Chinese policies now geared towards green finance developments, local and international asset managers believe that ESG integration will proliferate in years to come. Meanwhile, MAS has signalled its commitment to sustainable practices by encouraging financial institutions to adopt ESG best practices, while simultaneously supporting green bond issuances as part of its Green Bond Grant Scheme which launched in 2017.

Hong Kong’s SFC also announced in 2018 that it wanted to create a mechanism for asset managers to disclose to their clients the nature and to what extent they factor environmental criteria into their investment processes and risk assessments, in effect replicating some of the EU’s proposals. As a result, it is expected that ESG will become an important force in the APAC asset management industry in 2019.

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Americas:

Turning the heat on money laundering

Implementation of the Cayman Islands’ anti-money laundering (AML) legislation will have ramifications on asset managers who operate funds domiciled in the offshore centre. The revisions to the country’s AML Regulations demand that firms appoint an anti-money laundering compliance officer (AMLCO) to act as a point of contact with regulators; a money laundering reporting officer (MLRO) to whom staff must report any suspicious activities; and a deputy MLRO (DMLRO).51

Digital:

Technology comes under the regulatory spotlight

The buy-side is facing unprecedented change as new technologies such as Blockchain and artificial intelligence become increasingly integrated into the industry’s operational infrastructure. Simultaneously, digital assets (i.e. cryptocurrencies, tokenised assets, Initial Coin Offerings, [ICOs]) are slowly acquiring a loyal institutional investor following, which in turn may create a market for crypto-product solutions.52 Digital assets, however, have also caught the attention of international and regional regulators.

ESMA issued a consultation in January 2019 identifying a number of risks associated with digital assets including fraud, cyber-attacks, money laundering and market manipulation.53 Establishing a standardised legal status for digital assets needs to be carefully considered, according to ESMA, adding a “one-size-fits-all” solution is inappropriate given the industry’s diversity. However, an ESMA survey of member states found the majority were in favour of designating those digital assets with profit rights attached to them as being transferable securities or MiFID (Markets in Financial Instruments Directive) instruments.54

If digital assets are categorised as either transferable securities or MiFID instruments, then their issuers and the firms investing in them will be subject to a number of EU regulations including MiFID II, Central Securities Depository Regulation (CSDR), the Prospectus Directive, the Transparency Directive, the Market Abuse Directive (MAD), Short-selling Regulation and the Settlement Finality Directive.55 This growing regulatory interest in digital assets could herald increased oversight and supervision during the next 12 to 18 months.

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