



EU & UA – Aspects of Fund Regulatory Alignments

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Agenda

- **Introduction**
 - **EU – Ukraine Association Agreement (AA)**
- **Dimensions of EU Capital Market Legislature**
- **Concepts of Financial Regulation**
- **Concrete Example: AIFMD**
- **Implementation Aspects & Findings for UA**
- **Discussion**



Introduction

Introduction (1)

- **EU-Ukraine Association Agreement (AA) (I)**
 - new state in EU-Ukraine relations aiming at political association and economic integration
 - signed on 21 March 2014 (political chapters) and 27 June 2014 (economic chapters)
 - replaced the EU-Ukraine Partnership and Cooperation Agreement
 - includes provisions for a **Deep and Comprehensive Free Trade Area (DCFTA)**
 - will help to modernize trade relations and economic development by opening of markets via a progressive removal of customs tariffs and quotas as well as an **extensive harmonisation of laws, norms and regulations**
 - will help to **align key sectors of the Ukrainian economy to EU standards**

Introduction (2)

- **EU-Ukraine Association Agreement (AA) (II)**
 - *„Provisions for domestic regulation, postal and courier services, financial services and telecommunication services will improve transparency and legal certainty for EU investments in Ukraine. The focus here is on "behind the border" issues. “*
 - *“The DCFTA is complemented by a process of legislative approximation in financial services, telecommunications services, postal and courier services, and international maritime services. The Ukraine is committed to take over the existing and future EU-acquis in those sectors and, when it has done so, Ukrainian firms will be granted access to the EU internal market for the sectors concerned: this is an unprecedented level of integration. The approximation process will also mean that EU investors in those sectors will find the same regulatory environment in Ukraine as in the EU.”*



Dimensions of EU Capital Market Legislature

EU Capital Market Legislature (1)

- **Capital Market Legislature in the EU (I):**

- **Reports and Action Plans:**

- traditional approach: Expert Reports providing (policy) recommendations → trigger specific legislative process
- selectively: industry-demand for legislative actions
- newer approach: assessments of EC and ESAs

- **Trigger:**

- *Segré Report (1966)*
 - starting point of development of EU Capital Markets Law
 - independent expert group (incl. Segré, Lamfalussy) commissioned by EC
 - „*structure of equity markets*“; „*conditions for the development of a capital market integrated at European level*“;
 - focus on „*information policy*“
 - vague approach towards legal enforcement
 - first call for agency at European level

EU Capital Market Legislation (2)

- **Capital Market Legislation in the EU (II):**
 - **Phase I: Coordination of Stock Exchange and Prospectus Laws (1979-1982)**
 - *Segré Report* focussed on national stock markets and their trading
 - suggested a model prospectus
 - resulted in first legislative measures on law on stock exchanges and prospectuses
 - **Breakthrough 1: White Paper on Completing the Internal Market (1985)**
 - can be considered as key moment for development of European capital markets law
 - liberalisation of financial services at European level
 - ambitious ideas but realization only of one dossier: *Undertakings in Collective Investments in Transferable Securities (UCITS)* (Directive 85/611/EEC) → first pan-European financial regulation

EU Capital Market Legislature (3)

- **Capital Market Legislature in the EU (III):**
 - **Phase II: Harmonization of the Laws of Securities Markets (1988-1993)**
 - introduction of a *Directive on information to be published when a major holding in a listed company is acquired or disposed* (Directive 88/627/EEC)
 - followed by a *Directive coordinating the requirements for the drawing up, scrutiny and distribution of the prospectus to be published when transferable securities are offered to the public* (Directive 89/298/EEC)
 - seconded by a *Directive coordinating regulations on insider dealing* (Directive 89/592/EEC)
 - finally joined by a *Directive on investment services in the securities field* (Directive 93/22/EEC)
 - **Breakthrough 2: Financial Services Action Plan (1999)**
 - EC incentive with 42 measures to standardize EU-wide financial market
 - introduction of Euro caused a momentum
 - included (first) ideas for an EU supervisory structure

EU Capital Market Legislature (4)

- **Capital Market Legislature in the EU (IV):**
 - **Structural Input: *Lamfalussy Report* (2000)**
 - post-FSAP committee to evaluate the development of European capital market and legislative measures
 - main results of report: „*Lamfalussy process*“ (L1-L3)
 - **Phase III: Reorganization of the Laws on Prospectuses and Securities (2003-2007)**
 - existing framework needed clarity and efficiency (e.g. Directive EC/2001/34)
 - development of four core directives:
 - **Market Abuse Directive (MAD)** in 2003
 - **Prospectus Directive (PD)** in 2003
 - **Markets in Financial Instruments Directive (MiFID I)** in 2004
 - **Transparency Directive (TD)** in 2004

EU Capital Market Legislature (5)

- **Capital Market Legislature in the EU (V):**
 - **Transition Period towards Phase IV:**
 - *Takeover Directive* (Directive 2004/25/EC) adopted after numerous attempts
 - to meet the objective of „**better regulation**“, a *Green Paper* and a *White Paper on Financial Services Policy* (2005-2010) were published: harmonization of supervisory practices and standards
 - *De Larosi re Report* (2009) on future regulation and supervision of European capital markets
 - **Phase IV: Towards a European Supervision (2009 onwards)**
 - new European financial architecture: macro- and microprudential supervision by creating:
 - the **European Supervisory Authorities (ESAs)**: EBA, ESMA, EIOPA
 - **ESRB**

EU Capital Market Legislature (6)

- **Capital Market Legislature in the EU (VI):**

- **Phase V: Direct EU Supervision (2009- onwards)**

- *Regulation of CRAs* – Regulation (EC) No. 1060/2009
- direct supervision of CRAs by ESMA

- **Continuation of Phase V: Revisions and Updates**

- EC started numerous consultations to assess the implementation of existing directives and to find possibilities to simplify and improve them
- focus: MAD, Transparency Directive, MiFID, **Alternative Investment Fund Manager Directive (AIFMD) – Directive 2011/61/EU**
- *Regulation on Short Sales* – Regulation (EU) No. 236/2012
- *Regulation on OTC Derivatives* – Regulation (EU) No. 648/2012
- **adoption of significant amendments of MiFID (II), UCITS (IV, V)**

- **Phase VI: Towards a Capital Markets Union (2015- onwards)**

- *Commission Proposal for a CMU*



Concepts of Financial Regulation

Concepts of Financial Regulation (1)

- **Financial Regulation (1)**

- Considerations:

- **market failure as main economic rationale**

- two diverging strands of thoughts: *J.M. Keynes vs. F.A. von Hayek*

- *interdisciplinary* dimension of such regulation

- **associated rationales**

- systemic risks
- correction of other market imperfections
- need for consumer confidence and consumer protection
- moral hazard
- consumer demand for regulation
- other motives

Concepts of Financial Regulation (2)

- **Financial Regulation (2)**

- **Challenges:**

- institutional aspects
- legal aspects and enforcement issues
- international dimension
- product innovation and technology
- consumer over-protection, time and conflicts

Concepts of Financial Regulation (3)

- **Financial Regulation (3)**
- **Standard-Setting as Main Concept of International Framework for Financial Regulation**
 - Bank for International Settlements (BIS) – *Basel Committee*, active since 1988; banking regulation (www.bis.org)
 - International Organisation for Securities Commissioners (IOSCO) (www.iosco.org); securities regulation, CRA
 - Financial Action Task Force (FATF) (www.fatf-gafi.org); money laundering
 - International Monetary Fund (IMF) (www.imf.org); convergence of banking standards; crisis management; bailout

Concepts of Financial Regulation (4)

- **Financial Regulation (4)**
- **EU Institutional Supervisory Architecture:**

- **role of ESAs**



- **interplay with ECB**
- **role of ESRB**
- **interplay ESRB – ECB – EBA: SIFIs**

Concepts of Financial Regulation (5)

- **Financial Regulation (5)**
- Refinement of Market Integration as Regulatory Objective
 - new drive towards *pan-European* market access
 - **UCITS framework**
 - **AIFM framework**
 - third country challenges
 - complementary actions to be considered:
 - company law / corporate law
 - taxation
 - insolvency regimes
 - “one-size-fits-all” mentality in Brussels?

Concepts of Financial Regulation (6)

- **Financial Regulation (6)**
- **Institutionalization of Macro-Prudential Regulation**
 - macro-prudential supervision is a supervisory framework to monitoring systemic risk concerns
 - requires a **comprehensive range of information**
 - requires an **institutional setting**
 - European Systemic Risk Board (ESRB)
 - European Supervisory Authorities (ESAs)
 - requires a certain level of bureaucracy
 - causes challenges since old institutions seemed to be inadequate
 - requires **capacity to deal with risk-monitoring in an efficient and appropriate manner**
 - resulting in a “*form of general economic management importing more intervention by central banks*”?

Concepts of Financial Regulation (7)

- **Financial Regulation (7)**
 - GFC revealed a lack of regulatory discernment in terms of:
 - *unregulated parts* of the financial sector (such as AIF)
 - *complex financial transactions and linkages* (such as OTC derivatives)
 - resulted in a **significant expansion of reporting requirements**
 - causes extensive information surveillance on the side of the regulators
 - improving information and data collection frameworks
 - enhancing transparency of market activities
 - understanding of data and interconnectedness of financial system
 - IT infrastructure and know-how
 - significant extension to common disclosure regulation (such as **UCITS or MiFID framework**)
 - provides ground for more regulatory action due to better market knowledge

Concepts of Financial Regulation (8)

- **Financial Regulation (8)**
- **Expansion of Regulatory Powers for Information Collection**
 - fact that there is an overall increase in regulatory reporting
 - systemic risk can be triggered by institutional failure, therefore need for
 - **institution-based micro-prudential regulation**
 - **risk management information**
 - one result: European Markets and Infrastructure Regulation (EMIR):
 - trade and price reporting information
 - another result: AIFM-Reporting
 - risk data at fund and manager level
 - moreover: information about capital adequacy
 - **CRD and CRR**
 - stress testing (which is also introduced in other frameworks, such as UCITS)

Concrete Example: AIFMD

Regulatory Governance of AIFM (1)

- **Rationale for Regulation (I)**
 - Formal Aspects (I)
 - Trigger: GFC
 - G-20 summit in London (April 2, 2009)
 - Lehman Brothers; AIG; hedge funds as “locusts”; new dogma of systemic risk
 - EC publishes draft regulation on April 30, 2009
 - challenge: draft regulation itself
 - needed: **3** Council Presidencies, **1** Rapporteur, > **1600** amendments
 - agreement in trilogues on October 27, 2010

Regulatory Governance of AIFM (2)

- **Rationale for Regulation (II)**

- Formal Aspects (II)

- compromise:

• Date	Status /Review Process
• <u>X (2011)</u>	entry into force and publication
• X + 4 (2015)	review processes: <ul style="list-style-type: none">- ESMA- European Commission
• X + 6 (2017)	review process leading to AIFMD II?
• X + 7 (2018)	full implementation

Regulatory Governance of AIFM (3)

- **Rationale for Regulation (III)**
 - Material Aspects (I)
 - De Larosi re Report calls for inclusion of shadow banking system
 - EC: “*alternative investment funds could generate systemic risk in the future*”
 - connection to other financial institutions
 - trading activities
 - investment strategies including short-selling (see Regulation (EU) No. 236/2012 on Short-Selling and Certain Aspects of CDS)
 - potential investor losses
 - also market failures in investor and stakeholder protection

Regulatory Governance of AIFM (4)

- **Rationale for Regulation (IV)**
 - Material Aspects (II)
 - structure of AIFMD framework is:
 - **manager directive** (versus product directive)
 - **AIFM is in regulatory scope not the product (AIF)**

Regulatory Governance of AIFM (5)

- **Scope of AIFMD (I)**

- Principles

- *everything that is **non-UCITS** is AIF and therefore in scope*
 - no differentiation between open-ended or closed-ended
 - no differentiation in terms of legal form
 - no differentiation if traded on stock exchange, the amount of capital or number of investors
- *framework is targeting **institutional** investors*
 - unlike UCITS
- *introduction of a “**European Passport**”*

Regulatory Governance of AIFM (6)

- **Scope of AIFMD (II)**
 - Main Applications of AIFMD
 - all **EU-AIFM** that manage one or more **EU-AIF** or **Non-EU-AIF**
 - all **Non-EU-AIFM** that manage **EU-AIF**, no matter if they are distributed in the EU
 - all **Non-EU-AIFM** that distribute either **EU-AIF** or **Non-EU-AIF** within the EU
 - **Exemptions:** holding companies, IORP institutions and institutions in the area of social insurance and pension systems
 - **quantitative thresholds** are applied leading to “**registrations**”
 - **UCITS management companies** have certain privileges

Regulatory Governance of AIFM (7)

- **Legal Framework of AIFMD**
 - **Level I-Directive**
 - **Level II-Measures:**
 - Commission Implementing Regulation (EU) No. 447/2013
 - Commission Implementing Regulation (EU) No. 448/2013
 - Commission Delegated Regulation (EU) No. 231/2013
 - various Commission Delegated Regulations (EU)
 - since 2015: additional implementation measures
 - **ESMA Activities**
 - Consultation on Guidelines on Sound Remuneration Policies
 - Guidelines on Key Concepts of AIFMD and Types of AIF among others www.esma.europa.eu/page/Investment-management-0
 - since 2015: additional activities and guidelines

Regulatory Governance of AIFM (8)

- **Aspects of Prudential and Risk Management Regulation (I)**
 - **Capital Adequacy**
 - CA requirements imposed in respect of initial capital, own funds and additional own funds
 - differentiation if AIF is internally or externally managed
 - **Organizational and Risk Management Requirements**
 - regulatory focus on risk management (also from a prudential perspective)
 - organizational structure for risk management (see **MiFID** requirements) with reporting requirements
 - greater operational responsibilities, also in terms of internal control mechanisms

Regulatory Governance of AIFM (9)


- **Aspects of Prudential and Risk Management Regulation (II)**
 - **Liquidity Management**
 - requirement of liquidity management systems for AIFM
 - requirement of liquidity buffers to mitigate risks
 - **Remuneration Policies**
 - AIFM is required to establish remuneration policies and practices that are consistent with an effective risk management
 - **CRD III** serves as basis
 - broad application to senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the risk profiles of the managed AIFs

Regulatory Governance of AIFM (10)

- **Aspects of Prudential and Risk Management Regulation (III)**
 - **Restrictions on Investments and Investment Strategies**
 - „pre-approval“ of applied investment strategies
 - imposition of „short-selling“-restrictions
 - reduction of leverage in case of private funds in particular
 - restrictions in terms of investments in products which do not reflect at least 5% net economic interest in the underlying securities or FI
 - **Outsourcing and Delegation**
 - approval of outsourcing arrangements
 - outsourcing / delegation only to eligible entities
 - application of the concept of „*functional and hierarchical separation*“ of entities
 - requirements for sub-delegations and liability regimes

Regulatory Governance of AIFM (11)

- **Aspects of Prudential and Risk Management Regulation (IV)**
 - **Regulatory Reporting**
 - reporting obligations at AIFM and AIF level
 - standardized format and technical infrastructure
 - domestic to supranational level
 - **Investor and Stakeholder Protection**
 - duties in fund management (such as DD, care, effective resources, etc)
 - management of conflicts of interest (see **MiFID**)
 - separation of depositaries
 - valuation methods to be applied and approved valuation procedures
 - disclosure requirements (see **UCITS** analogy)
 - specific PE acquisition rules regarding non-listed companies



Implementation Aspects & Findings for UA

Implementation Aspects (1)

- **Implementation of EU Law (1)**
 - Implementation of EU law unfortunately varies from MS to MS due to:
 - **legal reasons**
 - Directive vs Regulation → trend towards Regulations
 - **transposition reasons**
 - MS delays in transposition (i.e. on purpose, too many legislative dossiers on the table)
 - treaty violation proceedings?
 - examples:
 - *FRA: 16 July 2013*
 - *GER: 22 July 2013*
 - *AUT: 29 July 2013*
 - *CZE: 19 August 2013 (plus specifics)*
 - *HUN: 16 March 2014*
 - *POR: 25 February 2015*
 - *SLO: 23 May 2015*
 - *POL: draft law December 2016*

Implementation Aspects (2)

- **Implementation of EU Law (2)**

- **governance reasons**

- delays at EU level cause a delay in implementation (i.e. MiFID II, PRIIPS, UCITS V)

- tight timeframes set by EC
- implementing legislation not ready or subject to intensive discussions
- shortening of duration legislative process at EU level due to increased political attention
- trilogues tend to speed up process

→ legal uncertainties

→ challenges for IT infrastructure and implementation

→ less consistency in national transpositions (unless EU Regulation)

Implementation Aspects (3)

- **Findings for UA (1)**

- current analysis of UA *banking environment* reveals a significant gap to EU standards
 - granularity of standards
 - materiality of standards
 - complexity of standards
- technical analysis has shown that EU-UA AA will lead to an upgrade of existing UA regulatory environment
 - challenge of conversion and transition to EU standards
 - AA is not always clear in terms of time horizon of transition towards EU standards (i.e. technical implementation measures)
 - challenge to understand the interconnections between various EU regulatory dossiers when implementing them in a different setting

Implementation Aspects (4)

- **Findings for UA (2)**

- EU-UA AA impact seems to lead to significant industry consolidations in both banking and securities markets
 - industry players often not ready/suitable to such level of regulation
 - implementation of new rules often imposed in a non-tailored, speedy manner
- EU-UA AA should also strengthen the economic and regulatory environment in UA in order to move towards EU standards
 - calibration needed
 - “translation” of EU language to UA understanding necessary
 - rationales of EU regulatory frameworks have to be kept in mind
- suggestion based on technical analysis: “one step after the other” is the most promising way forward



Discussion



**Thank you very much for
your attention!**

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