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# MiFID II: Fundraising in the EU for Non-EU Managers

## Curtis Insight: The Landscape for Non-EU-based Alternative Investment Fund Managers after the Introduction of MiFID II

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## 1. Introduction

The MiFID II Directive (2014/65/EU),[1] the new Markets in Financial Instruments Regulation[2] and supplementary legislation and guidance (collectively, "**MiFID II**") form part of the new legal framework governing the requirements applicable to, *inter alia*, investment firms, trading venues and data reporting service providers. MiFID II, which took effect throughout the EU on January 3, 2018, is intended to enhance investor protection and improve the operations of financial markets, their efficiency, resilience and transparency. It aims to make European financial markets safer thereby restoring investor confidence following the fallout from the financial crisis and covers the majority of the financial services industry, including banks, brokers, investors, asset managers and exchanges.

MiFID I generally does not directly apply to non-EU alternative investment fund managers ("**AIFMs**") as they fall outside of its scope. However, as we assess in greater detail below, a non-EU AIFM marketing an alternative investment fund ("**AIF**") in the EU, or with existing EU investors, may be indirectly affected by the requirements of MiFID II through its dealings with MiFID II-regulated EU investment firms (such as EU broker-dealers, portfolio managers and depositaries).

This Client Briefing addresses the impact of MiFID II on non-EU AIFMs who market AIFs in the EU via an intermediary.

## 2. What are AIFs and AIFMs?

AIFs are defined in the Alternative Investment Fund Managers' Directive (2011/61/EU)[3] ("**AIFMD**") as "*collective investment undertakings*, including investment compartments thereof, which: (1) *raise capital* from *a number of investors*, with a view to investing it in accordance with *a defined investment policy* for the benefit of those investors"[4] and (2) are not deemed Undertakings for Collective Investment in Transferable Securities ("**UCITS**") pursuant to the UCITS Directive (2009/65/EC).[5] All four elements of the definition must be present before an undertaking can be considered to be an AIF. An AIF can either be self-managed or externally managed by an AIFM.

An AIFM is an entity that is responsible for portfolio management and risk management services to one or more AIFs as its regular business, irrespective of where the AIFs are located or what legal form the AIFM takes.

## 3. Indirect Application of MiFID II to non-EU AIFMs

Both non-EU and EU AIFMs generally fall outside the scope of MiFI II. Article 2(1)(i) of MiFID II states that "this Directive shall not apply to collective investment undertakings and pension funds whether coordinated at Union level or not and the depositaries and managers of such undertakings."[6] Recital 34 of MiFID II also

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1 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU Text with EEA relevance

2 Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012

3 Directive 2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers

4 Article 4(1)(a) of Directive 2011/61/EU (emphasis added)

5 *Ibid*.

6 Article 2(1)(i) of Directive 2014/65/EU

states that "it is necessary to exclude from the scope of this Directive collective investment undertakings and pension funds whether or not coordinated at Union level, and the depositaries or managers of such undertakings, since they are subject to specific rules directly adapted to their activities." However, notwithstanding that non-EU AIFMs are not directly in the scope of MiFID II, there are circumstances in which non-EU AIFMs can be indirectly affected by MiFID II.

Non-EU AIFMs may be indirectly impacted by MiFID II requirements in their dealings with financial intermediaries. Article 1(1) of MiFID II provides that the Directive applies to "investment firms, market operators, data reporting services providers, and third country firms providing investment services or performing investment activities through the establishment of a branch in the Union."[7] The definition of "investment firm" in MiFID II includes any legal person whose regular occupation or business is the provision of one or more investment services to third parties, and/or the performance of one or more investment activities on a professional basis. This definition will include many parties who act in the financial industry, for example, brokers, asset and private wealth managers, investment banks and financial advisers. Therefore, in instances where a non-EU AIFM engages a third-party investment firm (such as a placement agent, investment adviser or broker) based in the EU to market interests in its AIF in the EU, those third parties may be subject to the requirements of MiFID II. Consequentially, such third-party investment firms will require the non-EU AIFM to contractually agree to comply with specific requirements of MiFID II to which the third-party investment firm is itself subject. In this way, a non-EU AIFM that markets interests in an AIF in the EU may be ***indirectly*** subject to MiFID II, regardless of whether its AIFs are domiciled in the EU or not.

## 4. MiFID II Requirements Indirectly Impacting non-EU AIFMs

### (a) Product Governance Guidelines

MiFID II requires EU investment firms to comply with certain product governance requirements, including target market assessments. The European Securities and Markets Authority ("**ESMA**") has published guidelines on product governance requirements regarding target market assessment by manufacturers and distributors of financial products.[8] EU investment firms must, for example, provide information on the type of client who is being targeted, the knowledge a prospective client should have for a specific product and the risk/reward profile of the product. Manufacturers and distributors of financial products governed by MiFID II must carry out regular product reviews to assess whether such product is consistent with the needs, characteristics and objectives of the identified target market and whether the intended distribution strategy remains appropriate.[9] In its guidance, ESMA requests that distributors of financial products (*i.e.*, interests in AIFs) "take all reasonable steps to ensure that the level of product information obtained from the manufacturer is of a reliable and adequate standard, to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the target market."[10] Distributors of AIFs established by a non-EU AIFM may therefore request such non-EU AIFM to provide a definition of the intended target

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7 Article 1(1) of Directive 2014/65/EU

8 ESMA, Guidelines on MiFID II product governance requirements (final report) [ESMA-35-43-620], published 2 June 2017, available at: https://www.esma.europa.eu/sites/default/files/library/esma35-43-620_report_on_guidelines_on_product_governance.pdf (the "**ESMA MiFID II Guidelines**")

9 As set forth in the ESMA MiFID II Guidelines: (i) the term "*manufacturer*" refers to a firm that manufactures an investment product, where manufacturing includes the creation, development, issuance or design of that product, including when advising corporate issuers on the launch of a new product; and (ii) the term "*distributor*" refers to a firm that offers, recommends or sells an investment product and service to a client

10 *See* ESMA MiFID II Guidelines

market and possibly also to enter into an agreement whereby the non-EU AIFM agrees to provide the distributor with information necessary to carry out its target market assessment. ESMA states that publicly available information is acceptable where it is "clear, reliable and produced to meet regulatory requirements"[11] (for example, information disclosed in compliance with the AIFMD would be acceptable).

Therefore, EU investment firms marketing AIFs of a non-EU AIFM to investors in the EU may require details from the non-EU AIFM to comply with this requirement.

### (b) Best Execution

When executing orders, EU investment firms must impose a "best execution" obligation to ensure that they are executing client orders on terms that are most favourable to the client, taking into account, *inter alia*, the price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. A "client" may include AIFMs and investors in AIFs of an AIFM. The obligation applies where a firm owes contractual or agency obligations to the client.

EU investment firms must therefore establish and implement an order execution policy, including information on the venues where the investment firm executes its client orders, and any factors affecting the EU investment firm's choice of execution venue. They must provide clear and detailed information to clients about the policy and how the investment firm will execute orders for the client.

Therefore, a non-EU AIFM engaging an EU broker may need to give consent, as a client of the broker, to any new order execution policy and may need to provide additional information to such EU broker relating to its AIFs so that the EU broker can comply with its best execution obligation to investors in such AIFs.

### (c) Reporting

MiFID II requires EU investment firms to provide clients with quarterly reports on portfolio management and, if such EU investment firm holds client financial instruments or client funds, it is required to provide such client with quarterly statements of those financial instruments or funds.

ESMA has outlined that the statement of holdings should include, *inter alia*:

i. details of all the financial instruments or funds held by the EU investment firm for the client at the end of the period covered by the statement;

ii. a clear indication of the assets or funds that are subject to MiFID II and its implementing measures, and those that are not; and

iii. the market or estimate value of the financial instruments, when available. If no market price is provided, then a statement should be given that this indicates a lack of liquidity. The valuation should be given on a best-efforts basis.[12]

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[11] *Ibid*.

[12] ESMA, ESMA's Technical Advice to the Commission on MiFID II and MiFIR (final report) [ESMA/2014/1569], published 19 December 2014, page 171, available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf

Therefore, where an EU investment firm holds interests in an AIF established by a non-EU AIFM on behalf of a client (*i.e.*, in its capacity as custodian or as part of a portfolio of investments), such non-EU AIFM may be expected to provide information to the EU investment firm to assist in preparing such quarterly reports and statements.

### (d) Unbundling and Inducements

Prior to the introduction of MiFID II it was common practice for investment firms to "bundle" trading and research costs together under a single, elevated commission fee, on the understanding that the investment firm would use the broker in question to carry out trades in return for access to their specialised research (a "soft dollar" arrangement). MiFID II has ended such "soft dollar" arrangements by forcing brokers to "unbundle" their research and trade execution costs and charge investment firms for them separately.

Under MiFID II, brokers serving investment firms need to identify separate charges for research costs and commissions. Research provided by any third party to an EU investment firm providing investment services will generally be classified as a prohibited "inducement" under MiFID II, regardless of the location of the third party, unless the investment firm either (i) absorbs the costs, paying for the research directly from its own resources; or (ii) passes the costs on to the client, by establishing a "Research Payment Account" funded with an advisory client's money and with the client's prior approval.

Therefore, a non-EU AIFM will find that, where it pays an EU broker-dealer for research costs, this will now be invoiced separately to its commission costs. EU broker-dealers will likely require non-EU AIFMs (as well as other clients) to agree new terms of business that address this "unbundling" of research costs.

## 5. Expansion of the Scope of MiFID II by Individual EU Member States

Non-EU AIFMs should also be aware that the transposition, implementation and enforcement of MiFID II rules may vary somewhat between the various EU member states. As an example, the FCA's second policy statement on MiFID II implementation (PS 17/14)[13] broadened the scope of the unbundling and inducement rules contained in MiFID II to apply them to UK AIFMs, UK branches of non-EU AIFMs and managers of UCITS. It will therefore generally be prudent for non-EU AIFMs to also assess the transposition, implementation and enforcement of MiFID II in each EU member state in which it markets, has investors, or may otherwise be subject to regulation.

[13] FCA Policy Statement 17/14: Markets in Financial Instruments Directive II Implementation – Policy Statement II (PS17/14), available at https://fca.org.uk/publication/policy/ps17-14.pdf.

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