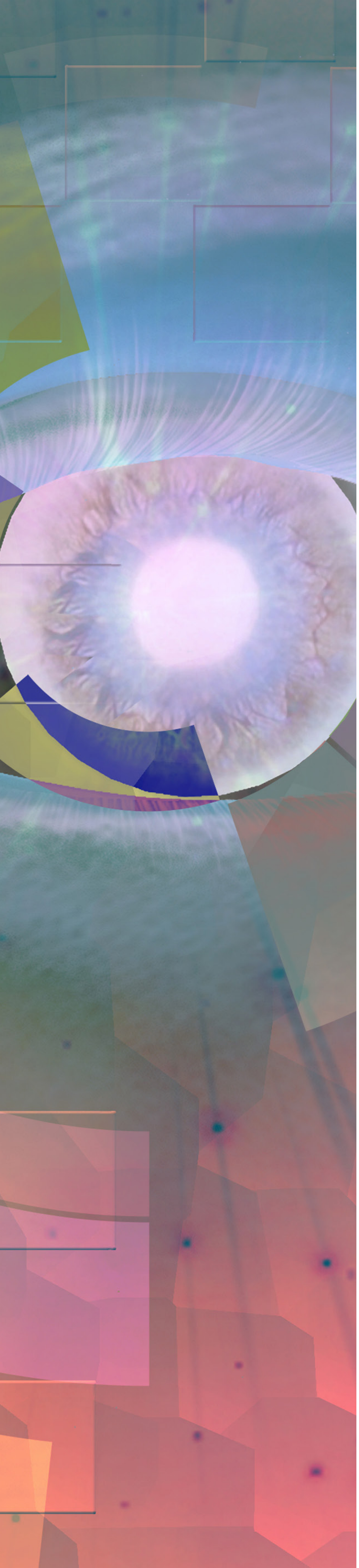
BROWN BROTHERS HARRIMAN

REGULATORY FIELD GUIDE

2020



REGULATORY
FIELD GUIDE

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2020: THE YEAR OF REGULATORY CLARITY AND PRECISION

Dear Reader,

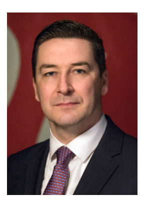
As we enter a new decade, it is an opportune time to reflect on what has passed, but also a chance to look ahead to future challenges and opportunities within asset management. If the last ten years were largely defined by large scale regulatory implementation, the next ten are likely to involve more focused revisions to existing rulesets as regulation looks to keep pace with societal and technological evolution.

Which brings us to the theme of this year's Regulatory Field Guide: clarity and precision. Regulators, to a much greater degree than in the past, are presenting a clearer view of what is expected from firms and investors. Greater levels of prescription and certainty within rulesets are helping industry constituents come to terms with the tangible benefits and effects of regulations. Greater transparency is also enabling these stakeholders to objectively view whether or not the regulation is working as intended.

While the focus for many regulatory developments this year will be on clarifying the finer details of a regulation, this does not mean there is a lack of "mega regulations" on the horizon. Brexit remains unfinished, the global focus on framing appropriate environmental, social, and governance (ESG) regulations will continue, as will the increasingly louder calls to more formally regulate the use of new technology. In such an environment it may be the most flexible and agile rather than the biggest and strongest who thrive.

With all that said, three areas stand out surrounding the global regulations of 2020: reporting, transparency, and modernization. With increasingly stringent reporting requirements, managers must ensure they have a proper data strategy in place to handle both the volumes and accuracy of data required. As the search for transparency continues, among regulators, investors, and asset managers, we're likely to get a closer look inside things like management fees, performance fees, and fund liquidity stress testing results. And as technological evolution accelerates across asset management, regulators must consider how to best oversee nascent technologies and asset classes to protect investors and monitor systemic risks without stifling innovation or better investor outcomes. It is a delicate balance that will set the tone for the industry throughout this decade.

Our 2020 Regulatory Field Guide contains insights from the regulatory experts at Brown Brothers Harriman and the asset management industry. We hope you find this guide helpful and informative as you grasp the intricacies of regulatory change throughout a year of increased clarity and precision.



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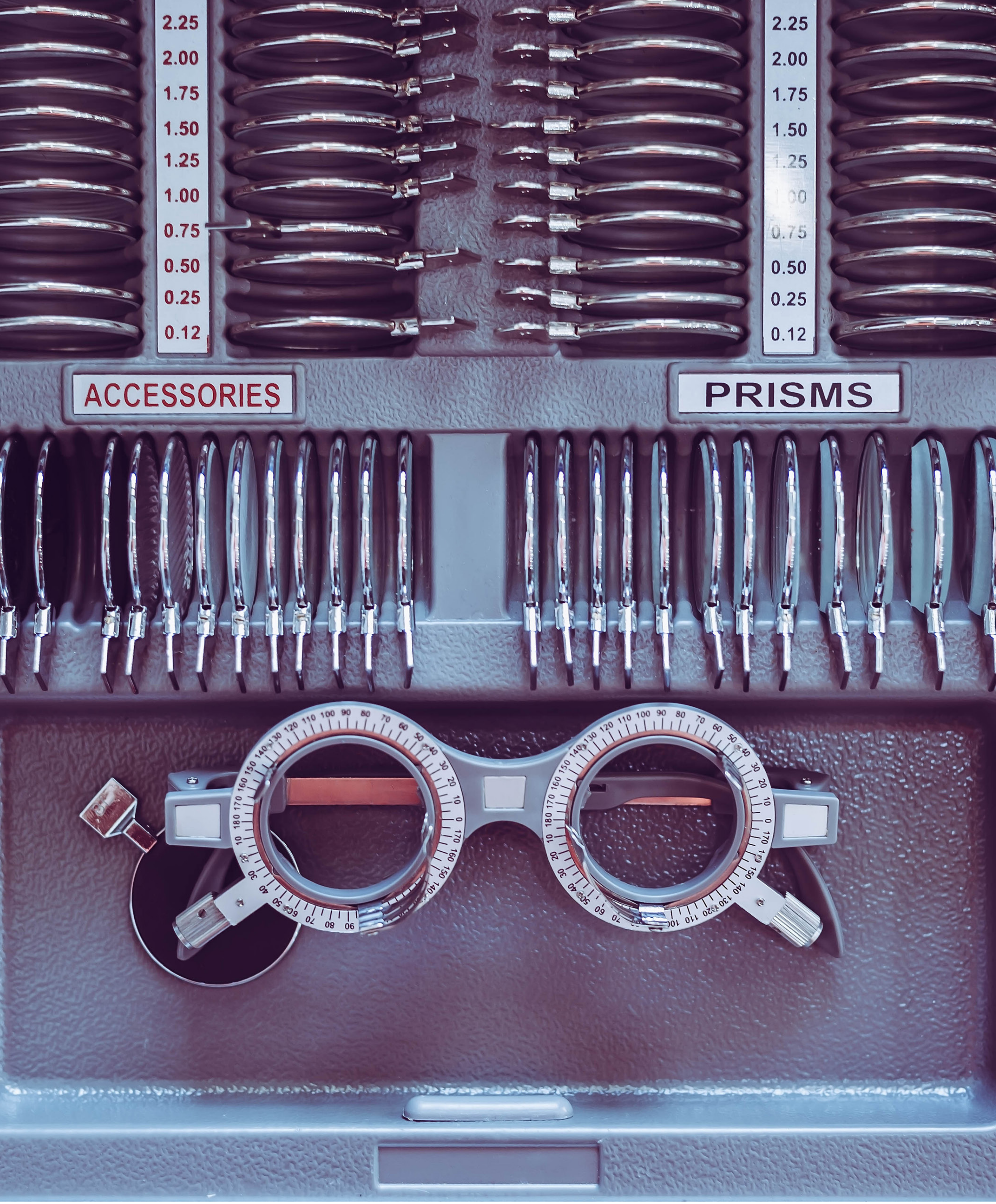
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2.00
1.75
1.50
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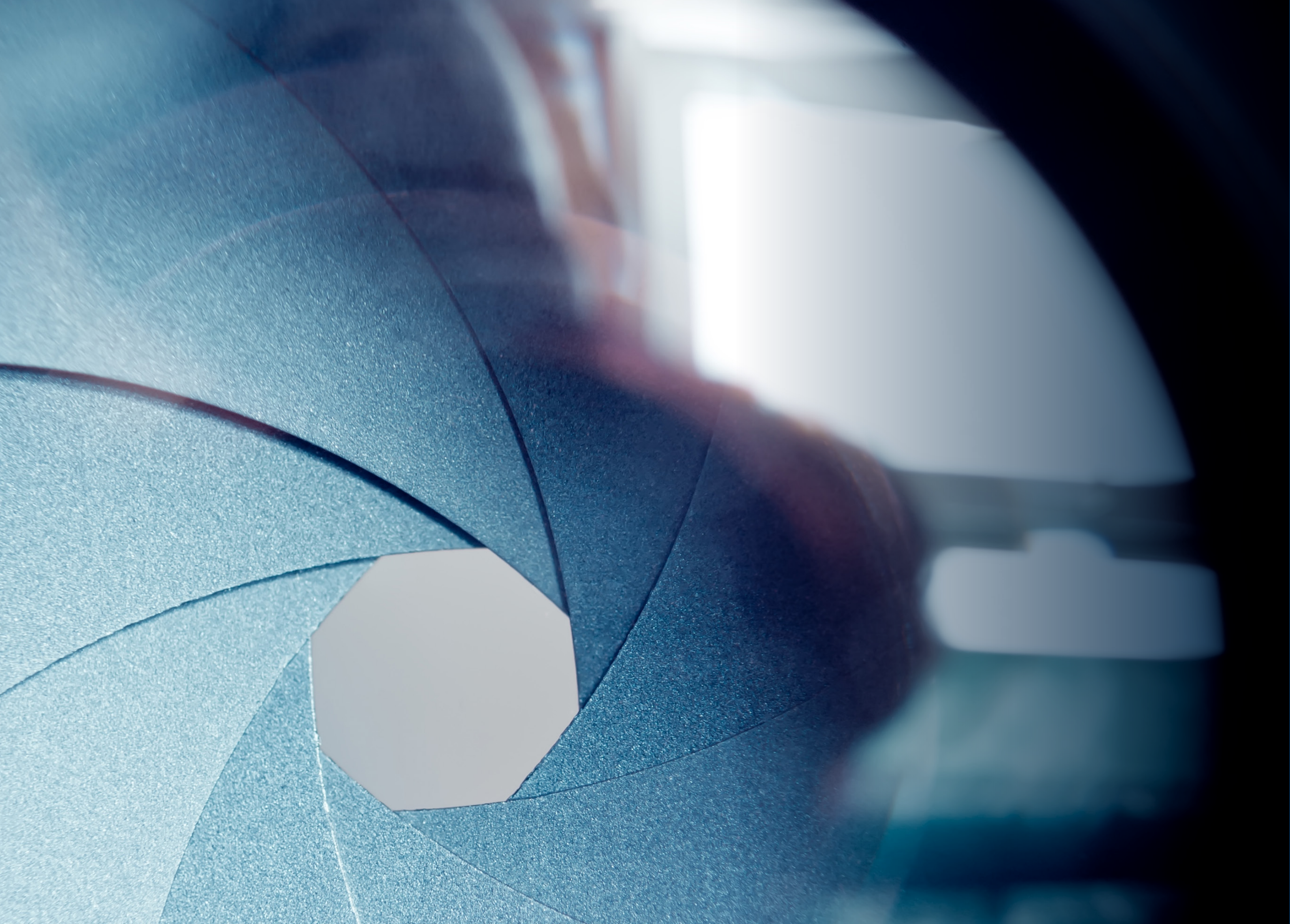
0.75
0.50
0.25
0.12
ACCESSORIES
PRISMS

CONTENTS



For All to See: The Wide-Angle Lens of SRD II

By: Derek Coyle and Bob Stewart

A sweeping new set of rules to improve communications between European companies and their shareholders, known as the Shareholder Rights Directive (SRD) II, takes effect September 3, 2020, imposing a number of new requirements on asset managers, custodians, and other intermediaries in the share-ownership chain.

SRD II was adopted by the EU in 2017, updating the original SRD passed in 2007. The goal was to encourage longer time horizons for shareholding, drive shareholder engagement, and require more transparency and accountability to shareholders regarding company director pay and conflicts of interest.

SRD II takes a long-term view

Taking note of the fact that the average shareholding period is only eight months, the European Commission said that "the performance of asset managers, employed by institutional investors to manage their assets, are often evaluated on a quarterly basis or even on shorter periods, which doesn't allow them to take into account long-term performance and puts pressure on them to deliver short-term returns."

In an effort to reverse what the EU saw as a negative trend, central securities depositories (CSDs), custodians, intermediaries, and asset managers will be required to:

- Answer requests from companies based in Europe for data about shareholders in their firms, often within 24 hours.
- Convey information about a company's general meetings to shareholders.
- Facilitate voting by those shareholders on issues at the general meetings.
- Convey those votes to the company or its agents, as well as inform the shareholder that the company had received their votes.

With more than 8,000 affected companies in the EU, the directive will apply to all firms in the custody chain that are holding European equities or investing in them, whether they are located within the EU or not, making it one of the most sweeping changes to corporate governance regulation ever. The administrative burden on firms across the globe will be substantial.

Conforming to GDPR and transparency requirements

Intermediaries will have to ensure that requests from issuers for shareholder data are legitimate and that they conform to the rules of the EU's General Data Protection Regulation (GDPR), which took effect in 2018 to protect the privacy of individuals resident in the EU.

The transparency requirements for annual general meetings (AGMs) are also elaborate. SRD II says that shareholders must be given sufficient notice of company events so that they can closely examine the various options. When shareholder votes are submitted to the company by electronic platform, the shareholders must be notified that their votes have been tallied within 15 days.

While the directive requires that companies have a right to data concerning shareholders, it provides that member states may limit the identification of shareholders to those holding at least half of a percent of the company's outstanding shares, which would limit the burden considerably.

Addressing misgivings over management pay

The EU has expressed concern that management pay at companies is sometimes out of step with the company's financial performance. As a result, SRD II requires that companies establish a remuneration policy, which must be submitted to the shareholders for a vote at least every four years, and submit a pay report for an advisory vote annually. If these votes fail to gain approval, the directive provides some key follow-on steps.

SRD II also imposes rules governing administrative costs, including for implementing SRD II itself. For example, intermediaries need to be transparent about proxy costs and the provision of proxy services, which should be published visibly (such as on a company website) so both end investors and regulators can find it. It is likely that SRD II will mean that global proxy notifications would become a mandatory service, where it is currently an elective option for the EU locations in scope.

The directive provides that any charges levied by an intermediary on shareholders, companies, and other intermediaries should be non-discriminatory and proportionate to the actual costs incurred for delivering the services. In addition, any difference between the charges levied between domestic and cross-border exercise of rights must reflect the actual costs incurred for delivering the services.

Another requirement is that investment firms and institutional investors must now publicly disclose their shareholder engagement policy, which explains how they plan to integrate shareholders into their investment policies – or if they don't plan to do that, publish an explanation of why not.

SRD II also contains language requiring a code of conduct for proxy advisers, the firms that research and advise asset managers on how to vote on issues at AGMs. It provides that proxy advisory firms should provide accurate and reliable recommendations to the firms they advise, but does not spell out how it expects this issue to be implemented.

In summary, it's clear that SRD II represents a heavy administrative lift requiring action in 2020. Custodians and financial institutions are expected to be the first intermediary in the chain for most communications in order to respond to or redistribute requests as soon as possible. Asset manager and institutional investor readiness for SRD II focuses on the definition of shareholder engagement policies that highlight transparency and long-term thinking in their approaches.

BBH will continue to support messaging regarding general meetings, proxy notifications, and corporate actions, and will meet the same day turnaround times to either answer such requests, or pass them on through the intermediary chain as needed.

In Transition: What's Next for LIBOR

By: Bijal Shah

Because credit lubricates the machinery of just about every aspect of the financial industry, figuring out how to manage the looming retirement of the interest rate benchmark known as the London Interbank Offered Rate (LIBOR) has moved to the front burner for many firms as they head into 2020.

Although LIBOR will not completely disappear from the market until the end of 2021, the need for an end-to-end credit rethink – from examining all documentation that refers to LIBOR, incoming and outgoing loans, client arrangements, and a deep dive into a panoply of risk functions – means that the process must be well underway before the deadline nears.

Complicating matters for market participants, LIBOR is the interest rate benchmark used to price mortgages, credit card rates, and an estimated $300 trillion in fixed-income derivatives, and while LIBOR is sure to go away, no single replacement rate has been agreed. Instead, five so-called risk-free rates, which might more accurately be termed "nearly risk-free rates," have been developed.

Among the five, the main contenders are the Secured Overnight Financing Rate (SOFR), which the Federal Reserve introduced as a LIBOR alternative in the US, and the Sterling Overnight Index Average (SONIA).

LIBOR is calculated from a daily survey of 20 leading banks in London, which left the process open to a rate-fixing scandal. SOFR, on the other hand, is based on Treasury overnight repurchase agreements, or repos, while SONIA is calculated by the Bank of England from interest paid on Sterling one-day deposits.

The Federal Reserve has been pressing financial firms aggressively to adopt SOFR as soon as possible. Federal Reserve Bank of New York President John Williams has expressed concern that firms were dragging their heels in transitioning to the new benchmark. "I don't always sense urgency among market participants on this issue," Williams said. "Tellingly, contracts referencing US dollar LIBOR, without robust fallback language, continue to be written" he said in an August 2019 speech.

To ensure the transition moves ahead, the US government has started flexing its considerable muscle to promote adoption of SOFR. Mortgage guarantee agency Fannie Mae has issued $6 billion of SOFR-linked bonds and the Federal Housing Finance Agency, which regulates Federal Home Loan Banks, said the institutions shouldn't issue new financial instruments tied to LIBOR after the first quarter of 2020. The 13 banks have about $221 billion in outstanding LIBOR-connected notes.

SONIA is also getting attention, with the European Investment Bank issuing a £1 billion SONIA-linked bond, the first SONIA-linked floating rate note. The bond provides for quarterly interest payments at the compounded daily Sonia-rate plus 35 basis points per year. The World Bank also has issued two SONIA-linked £1.25 billion bonds.

In preparation for the transition to risk-free rates, the Financial Stability Board, the international financial monitor set up in the wake of the Great Recession, called on the International Swaps and Derivatives Association (ISDA), the derivative industry's trade body, to add what it termed a "pre-cessation trigger" into contracts for derivatives that still reference LIBOR. The reasoning is that if LIBOR ends for some reason prematurely, derivatives should be switched to the risk-free rates.

Drawbacks of replacement rates

One problem for many financial institutions is that the new risk-free rates are backward-looking interest rates, while LIBOR is a term rate for seven different maturities with a built-in term credit risk premium, which risk-free rates do not contemplate. As a result, finding the future cost of loans and derivatives is more problematic using the risk-free rates, which are composed of synthetic terms based on three-month averages of the overnight rates.

Because of this complexity — the final interest rate is often not known until after the term has expired — financial firms need to understand what this sea change actually means for their business. So far, the industry approach to products based on the new benchmarks has been cautious.

For example, the Eurodollar futures market is a bet on future interest rates paid on dollar deposits outside the US. Many firms use these derivatives to hedge against interest rate swings, but without a term rate, that will be more difficult. The Chicago Mercantile Exchange has started issuing Eurodollar futures based on SOFR, but there has been limited uptake by investors so far.

SOFR's implementation hit a temporary snag in September 2019 when turmoil in the US money markets prompted the repo rate to spike, causing SOFR to reach 5.25 percent temporarily before the Fed intervened by injecting cash into the market. It was an alarming lesson, causing some market participants to avoid SOFR-linked debt, at least temporarily.

An urgent need to focus on risks

As part of the preparations for the transition away from LIBOR, regulators are asking financial firms to demonstrate their readiness to make the change. In a letter to the CEOs of major banks, the UK's Financial Conduct Authority (FCA) and Prudential Regulation Authority asked that that firms' senior managers and boards "understand the risks associated with this transition and are taking appropriate action now so that your firm can transition to alternative rates ahead of end-2021."

Perhaps because the changeover has its roots in the LIBOR scandal, the UK's FCA is also trying to get firms to focus on conduct risk – behavior that might harm customers or have a negative effect on the financial system during the transition. For example, it is trying to ensure that clients don't get overcharged for the new rates. The acid test, as FCA Chief Executive Andrew Bailey puts it, is whether firms are seen to have done right by their customers.

"For many, LIBOR transition will impact their overall business strategy and front-office client engagement, rather than being a narrow legal and compliance risk," the FCA said. "Potential impact and risk therefore needs to be considered and addressed in an appropriately coordinated way across a firm."

What's next

If LIBOR transition isn't incorporated into project planning for 2020 it should be. As we described, regulators are keen to see some demonstrable progress from firms with clear evidence of strategic planning. The closer we get to 2021, the date from which the FCA will no longer compel banks to maintain the LIBOR rate, the less integrity associated with LIBOR. Alternative rates will start to increase in prominence, liquidity, and infrastructure, and therefore should start to look more viable.

However, this move is a process, not an overnight deliverable, as so many areas of a firm's business are involved in the transition. In order for a successful transition, this move needs careful global choreography to avoid pitfalls attendant to international regulatory arbitrage. The first step is to determine which benchmark to rely on. SONIA has been in existence for long enough to prove a credible alternative for sterling, but it will remain to be seen whether the US dollar replacement SOFR can win the confidence of the critical mass. Whatever it takes for issuers, lenders, borrowers, and other users of LIBOR to get comfortable with the benchmark alternatives, one thing is for sure – they must find an alternative.

China Sets Sight on International Access

By: Chris Pigott

As the Chinese mutual fund industry continues along its reform agenda of internationalization, regulatory developments are driving new opportunities. Historically, access for foreign asset managers has been highly restrictive, but plans made in 2019 and new options available in 2020 are presenting opportunities for foreign asset managers to evaluate. The ability for asset managers to increase their access to this market could be a once in a lifetime opportunity for the industry – there is no other place in the world where trillions of dollars of new capital are up for grabs for asset managers.

Foreign majority ownership

One of the most noteworthy developments in recent years has been the China Securities Regulatory Commission (CSRC) paving the way for foreign asset managers to take a majority ownership position in their joint venture fund management companies (FMC). As part of the original proposal, foreign ownership caps will be fully removed by 2021, which would allow foreign asset managers to take 100% ownership of the domestic FMC. In July 2019, the CSRC announced a series of policies to further open the financial sector. This included accelerating the timeline for removing FMC foreign ownership limits by one year to 2020. The CSRC subsequently clarified that effective April 1, 2020, FMC foreign ownership limits will be removed altogether.

Setting up business in China

One of the more popular options for foreign asset managers setting up businesses in China has been the Wholly Foreign Owned Enterprise (WFOE) route. As of October 2019, there were more than 50 investment WFOEs with two viable paths for structuring onshore products:

1. Applying for a private fund management (PFM) license to set-up domestic private funds
2. Applying for quota for the Qualified Domestic Limited Partnership (QDLP) scheme and launching domestic funds

WFOEs provide foreign asset managers the ability to set-up a domestic funds business, engage with regulators, establish servicing relationships, as well as understand the onshore distribution dynamics. For most foreign managers, WFOEs have been a stepping stone in their strategy with the end goal of establishing a retail funds business through an FMC. This path became clearer in August 2019 when the Asset Management Association of China (AMAC) announced they will welcome PFM WFOEs to enter the China public fund industry. At this point, no further guidelines related to the conversion of a WFOE to an FMC have been announced, but it seems there is an option to simultaneously operate a PFM and FMC. There is some precedent where domestic PFMs have transitioned to FMCs, but it is not clear if the same requirements would be applicable to foreign asset managers going through this process.

Aligned with the removal of FMC foreign ownership limits, the expectation is for a group of existing PFM managers to apply for their FMC license in the first half of 2020. Pivoting from a PFM business that limits the managers to distribute products to qualified Chinese investors to an FMC business that provides access to the full retail market will come with new operational and distribution challenges.

Outsourcing pilot

As foreign players develop their public fund strategy, Chinese regulators are further evaluating areas where their market is different than international standards. An area of recent focus is the outsourcing of core operational tasks including the fund's valuation, transfer agency, and financial reporting. Globally, it is common for these operational tasks to be outsourced to third-party providers, while in China, the FMC is responsible for these roles. As a result, FMCs have built out operational teams within their firms to perform NAV calculations and other operational responsibilities.

Outsourcing is beginning to make more progress in China. Aligned with foreign managers applying for FMCs, the regulator is evaluating a public fund outsourcing pilot for onshore banks and securities firms. This pilot would allow the outsourcing of certain operational tasks to third-party firms. The rules for this pilot have yet to be announced, however, it is understood that both the outsourcing provider and the FMC would need to undergo on-site inspections to ensure the appropriate control environment is in place including, but not limited to, systems, experienced personnel, and oversight best practices. The announcement is expected to coincide with the first foreign managers receiving their FMC license subsequent to the removal of the foreign ownership limit in April 2020. Once the licenses are issued, the clock begins and managers will have six months to launch a product.

Currently in China, outsourcing is much more prevalent in the private funds space and those tasks are mostly performed by securities firms. For public funds, there is one example of an approved outsource arrangement, which was completed in 2017.

What's next?

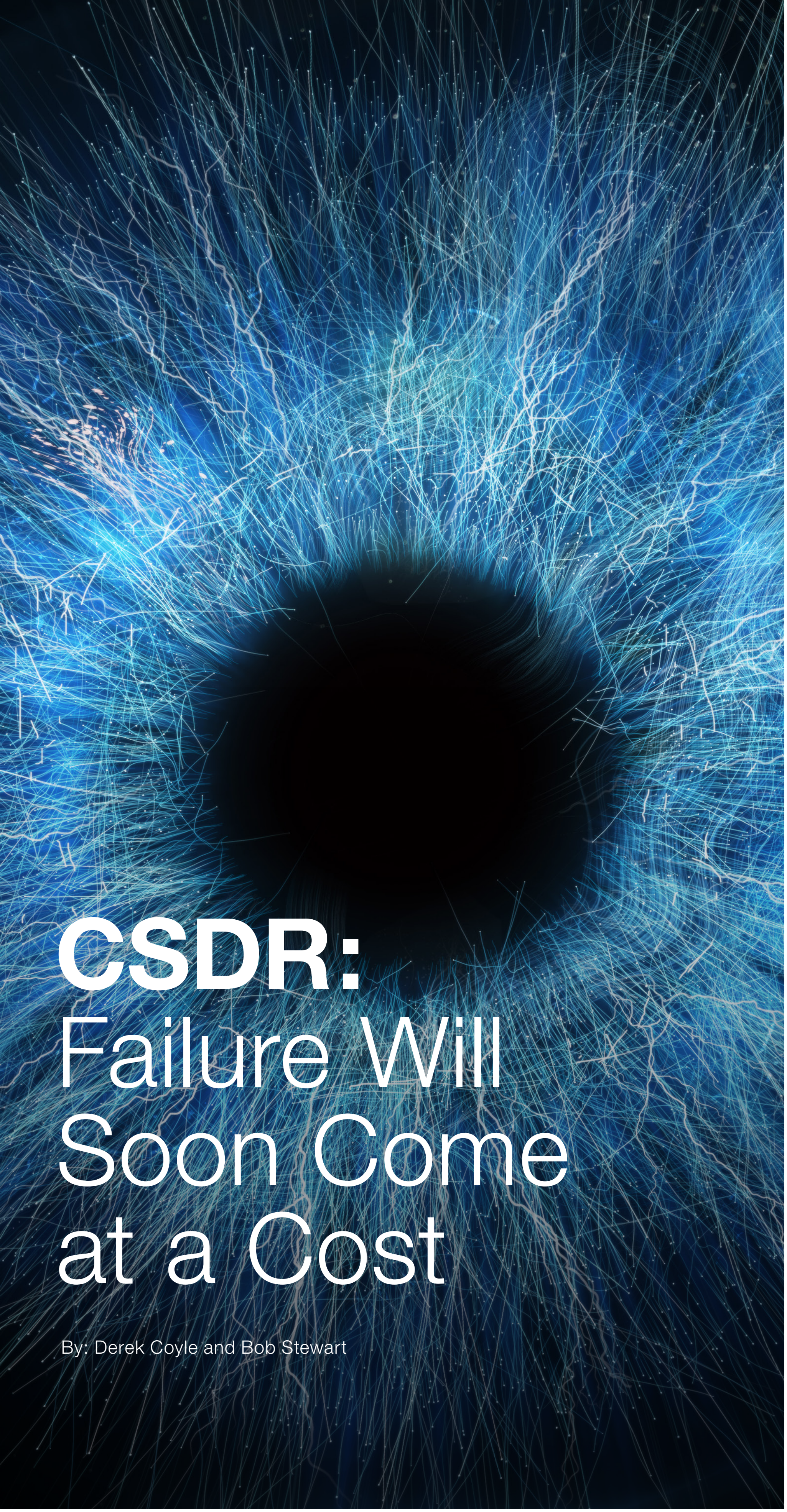
As we head into the next phase of the China market development, foreign asset managers will have a role to play. As highlighted by operational outsourcing, the domestic market operates in a manner that doesn't follow other global markets.

> *"The ability for asset managers to increase their access to this market could be a once in a lifetime opportunity – there is no other place in the world where trillions of dollars of new capital are up for grabs."*

Flexibility and patience will be critical as foreign asset managers continue to develop their China strategy and expand their onshore footprint to capitalize on the expanding pool of capital that resides outside the asset management industry.

It is clear the sophistication of the market and investors continues to increase as the capital markets continue to open to foreign participation. The reform agenda will progress with a focus on shifting assets into the traditional channels away from the legacy bank wealth management products. Policies that are specific to inbound investment is also being updated to ease foreign access to the onshore equity and bond markets.

As we all know, change in China can happen rapidly and optionality is important for any onshore strategy.



CSDR: Failure Will Soon Come at a Cost

By: Derek Coyle and Bob Stewart

An old investing adage holds that success has many fathers, but failure is always an orphan. Beginning in 2020, cross-border settlement failures will also come with a new set of potentially costly penalties thanks to the new settlement discipline rules contained in the EU's Central Securities Depository Regulation (CSDR).

Adopted in 2014, CSDR was primarily aimed at harmonizing the way central securities depositories (CSDs) operate across the EU. Some 15 CSDs now have the official stamp of approval and operate with the strict prudential and conduct rules that CSDR established.

But CSDR also contained a provision to establish "settlement discipline" that begins to bite in November 2020. Industry associations are proposing for a further implementation delay, potentially to early 2021, in order to allow for better operational readiness to support the settlement discipline regime. In an effort to reduce the number of settlement failures in the EU, the new CSDR rules provide for two penalties:

- Cash penalties for failed settlements, with a basis point penalty applied depending on the type of asset involved.
- A mandatory buy-in mechanism after four business days of failing.

The new rules are important for both buy-side and sell-side trading desks to prepare for and apply to non-EU counterparties as well.

For the uninitiated, a buy-in is a contractual remedy for a buyer of securities when the selling counterparty fails to provide settlement of the purchased securities on time. The buying counterparty obtains the

"While most market participants have welcomed the efforts to streamline the settlement process, the new rules also have a potential downside: they could dampen liquidity in the debt securities market by making it more difficult for borrowers and lenders to efficiently trade bonds."

securities from a third-party, and if the price is higher than at the time of the original sale, the selling counterparty has to make up the difference. While previously optional, the buy-in process now becomes mandatory for liquid securities four business days after the intended settlement date (ISD+4 in EU parlance) and in seven days for illiquid securities (ISD+7). If the buy-in mechanism is unsuccessful, the selling counterparty has to pay a cash penalty to the buyer equal to the difference between the original agreed price and the current market value of the securities.

The regulation states that third-party buy-in agents (most likely brokers and dealers) will support the buy-in and the counterparties will trigger the buy-in by engaging the buy-in agent to source available securities from their failing counterparty. Custodians will manage the communication and operational support needed to facilitate trade settlements.

The EU regulation made clear that the intention was to impose different cash penalties for settlement failures based on the liquidity of the assets involved. "Where shares have a liquid market and could therefore be bought easily, settlement fails should be subject to the highest penalty rate in order to provide incentives to failing participants to settle failed transactions in a timely manner," the regulation states. "Shares that do not have a liquid market should be subject to a lower penalty rate given that a lower penalty rate should still have a deterrent effect without affecting the smooth and orderly functioning of the markets concerned."

How CSDR will play out

Market participants generally communicate their purchases and sales using the European Central Bank's Target2 Securities (T2S) platform or through their CSD. According to the new rules, CSDs will calculate cash penalties daily for each business day that a transaction fails to be settled after its intended settlement date (ISD) and report the cash penalties through the chain of custody. Penalties will roll over from day-to-day until the settlement takes place. Penalties can be calculated using what are called Late Fail Matching Penalty (LFMP) or Settlement Fail Penalty (SEFP) definitions.

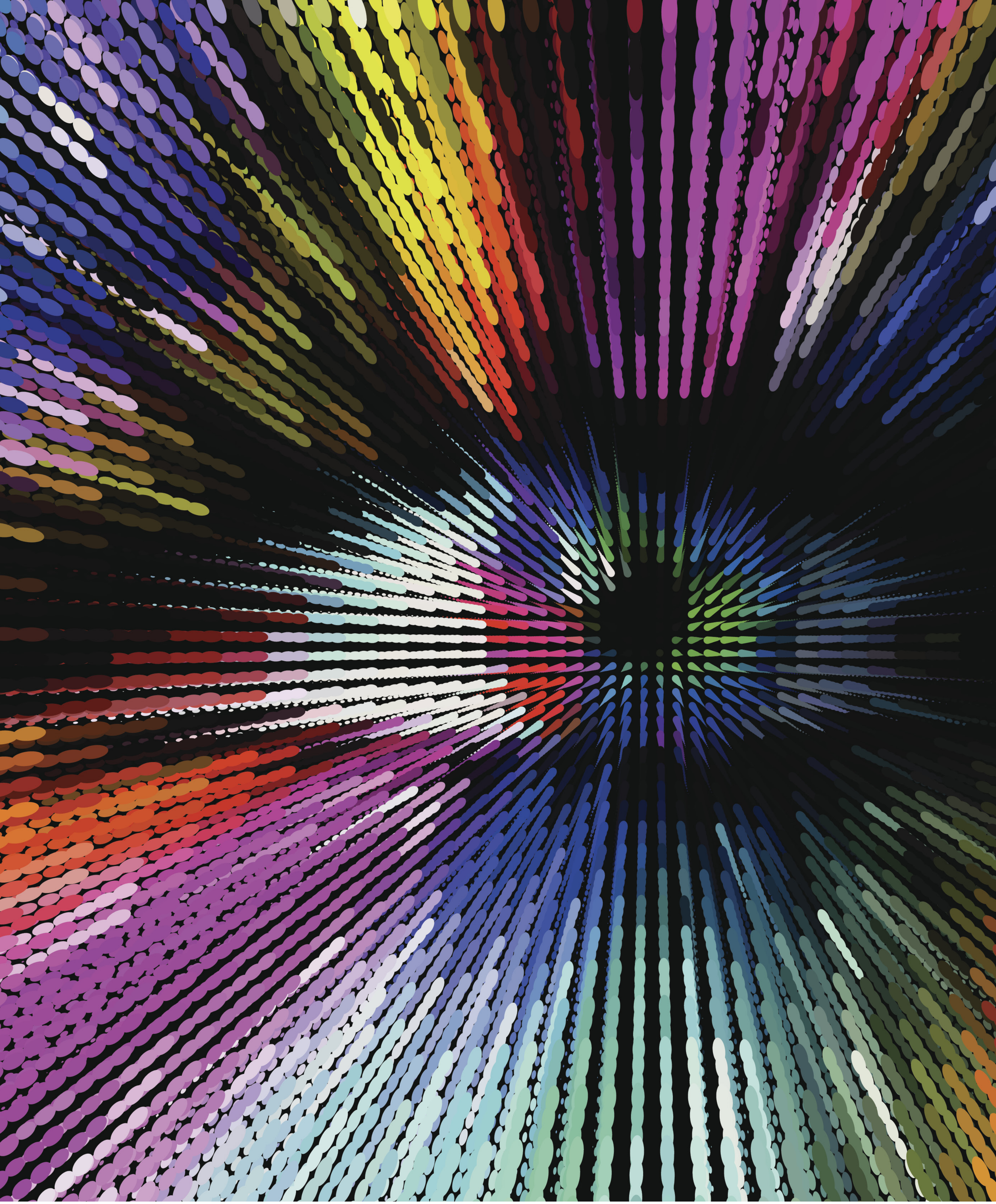
In the case of appeals there is a 10-business day period after the receipt of the monthly penalty summaries in which a penalty can be appealed and, in some cases, adjusted before final penalty settlement is expected.

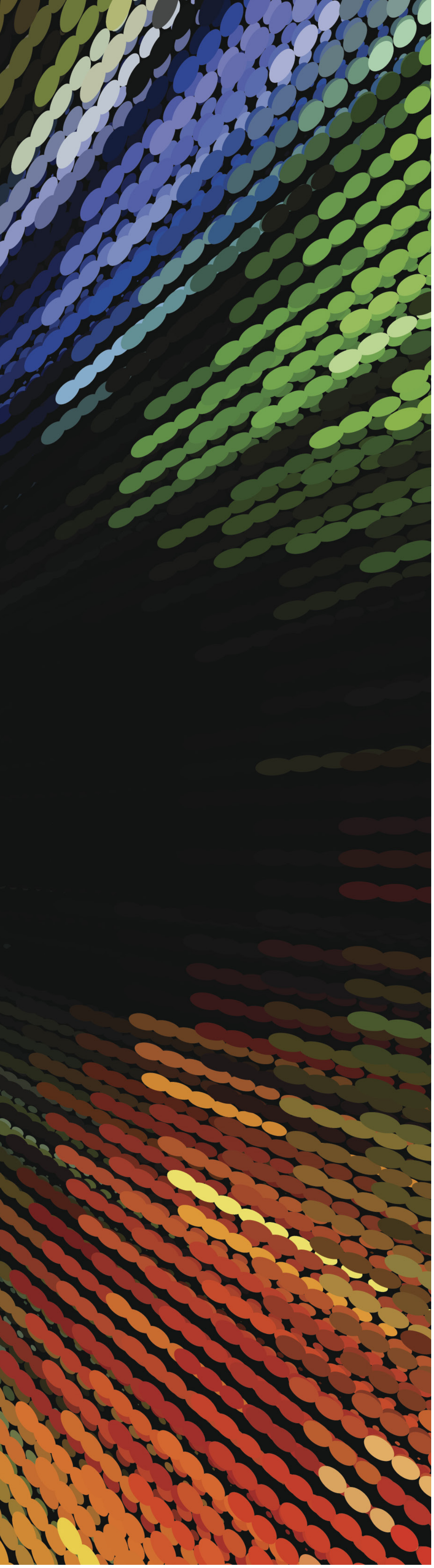
As a result, CSDs, custodians, and both buy-side and sell-side market participants are making significant investments to develop their back- and middle-office systems and processes to reduce the chances for a settlement failure and, when failures do occur, to determine liability and ensure cost is attributed to the responsible party. This could be especially difficult when there are multiple parties within a given train of transactions.

While most market participants have welcomed the efforts to streamline the settlement process, the new rules also have a potential downside: they could dampen liquidity in the debt securities market by making it more difficult for borrowers and lenders to efficiently trade bonds. For example, the International Capital Markets Association (ICMA) said in a study of the impact of the mandatory buy-in provisions that "liquidity across secondary European bond and financing markets will reduce significantly, while bid-offer spreads will widen dramatically."

ICMA argued that spreads on liquid sovereign bonds may double and secondary markets for less liquid corporate bonds may "effectively close." It suggested that the rules might force market makers to retrench from providing liquidity to the market. Buy-side traders need to be aware of the possibility that market liquidity in debt may be in short supply.

Based on the push for delay, CSDs may get an extra few months to comply, but that would need be confirmed by ESMA and the EU Commission. Something to watch in 2020.





A New Vision:

Regulators Push ETFs to Modern Era

By: Eamonn O'Callaghan, Chris Pigott, and Ryan Sullivan

With assets in exchange traded funds (ETF) growing to over $6 trillion globally at the end of 2019, it might seem hard to imagine how ETFs have further room to grow. However, separate decisions by regulators to ease ETF registration and permit the issuance of several new fund breeds — ranging from so-called semi-transparent funds in the US to comingled listed and unlisted shares in an ETF structure in Ireland — are likely to keep the boom alive for years to come.

Beyond new ETF product types, global regulators continue to assess liquidity and counterparty risks relating to the ETF market and whether further mitigants are needed. So far, they've stopped short of proposing any additional limits. New European rules about settlement failure could prompt changes to market structure and product design. And in the Asia Pacific region, regulators are positioning ETFs for further growth and scale. Here, we break down key regulatory developments in the US, Europe, and Asia Pacific regions.

US leads the regulatory easing

In the US, we expect to see a new crop of managers enter the ETF space in 2020, thanks to two decisions handed down by the Securities and Exchange Commission (SEC).

Adoption of Rule 6c-11 (dubbed the ETF rule) will have far-reaching implications. Ever since the first US ETF was born in 1993 (the S&P 500 SPDR), the SEC required ETF sponsors to go through a lengthy and costly process to obtain what it called "exemptive relief" from the 1940 Investment Company Act ('40 Act).

However, in 2019, the SEC publicly recognized the benefits of ETFs to US investors and sought to enshrine these products with their own regulatory framework, rather than continue to shoe-horn approvals under regulations intended for mutual funds. In 2020, ETFs that qualify for the rule (e.g., '40 Act open-ended RICs) can simply file a registration statement and comply with the applicable ETF regulations.

1. The adoption of the ETF rule helped to modernize ETFs and create a more even playing field for managers. A key element of the regulation permits and standardizes the use of custom baskets for all ETF issuers. ETFs publish a basket of securities each day, usually based

> *The impacts of CSDR may be felt by an ETF holding European securities, regardless of the funds' domicile."*

on an index or a pro-rata slice of the fund's holdings, to inform authorized participants (APs) what securities to deliver to the fund when creating ETF shares, or what securities they should expect to receive when redeeming. Custom baskets allow ETF managers to create baskets for specific create or redeem orders which can help improve the fund's tax efficiency and liquidity. However, only a subset of managers had SEC approval to use these types of baskets. This provision in the ETF rule should allow for a more consistent approach and oversight in how custom baskets are used.

Additional provisions in the rule did away with the requirement of an intraday indicative valuation (IIV) and clarifies ETF disclosure policies of fund holdings and secondary market trading metrics.

2. The second major development focused on active ETFs and gave a boost to a new class of ETF structures that will not have to disclose their current holdings to the public on a daily basis. This change had long been sought by active managers concerned about tipping off the market as to the implementation of their investment strategies.

   A number of firms had proposed various approaches to changing the disclosure requirements of ETF holdings, including Precidian, the New York Stock Exchange (NYSE), Fidelity, Blue Tractor, and T. Rowe Price. Precidian's ActiveShares[SM] ETFs became the first to win SEC approval in late spring, followed by other so-called proxy-based, non-transparent active ETFs.

Following these moves by the SEC, the listing exchanges (NYSE, NASDAQ, and CBOE) all sought rule changes that would make listing ETFs more consistent with the new ETF rule. ETFs that qualify for 6c-11 will automatically fall under the exchanges' generic listing standards, remove the IIV from listing requirements, and reduce the necessary seed capital to list an ETF to $100,000.

With the new disclosure policies available and the ETF rule making it easier to launch products, managers will have more choices available to enter the ETF market. Active firms that have been on the sidelines now have a new path to protect their IP and take advantage of the lower cost and tax-efficient ETF wrapper.

Europe gauges the risks

Across the Atlantic, European regulators haven't yet accepted the SEC's liberal views on transparency. Instead, their focus has been on the upcoming implementation of the Central Securities Depository Regulation (CSDR). ETFs are likely to be heavily affected when the regulation starts imposing what is termed "settlement discipline" later this year, penalizing settlement failures with two types of fines.

The reason ETFs are likely to be the first to suffer is that ETFs often have a high rate of settlement failure. That's because of a structural mismatch between the ETF and the underlying securities: the ETF shares may settle in two days (T+2), while the investments underlying the ETF shares may require five or more days to deliver (T+5).

Two things may happen in 2020 as a result. Increased costs to ETFs for failures could be passed on to investors. Alternatively, the market may be prompted to change the way the system operates, particularly the way in which APs create and redeem shares. These impacts may be felt by an ETF holding European securities, regardless of the funds' domicile.

Another regulation that is likely to impact the European market is the Central Bank of Ireland's (CBI) decision to allow sponsors to comingle ETFs and unlisted (mutual fund) share classes in the same UCITS structure. With comingled assets, the ruling promotes economies of scale, attracts investors who prefer investing via the mutual fund wrapper, and may succeed in attracting new institutional investors that have minimum fund size thresholds for investment. A similar rule exists in Luxembourg, which is the second largest ETF domicile in Europe. In the US, funds with comingled mutual fund and ETF share classes are only offered by Vanguard as they have a business method patent on this structure. [Notably, the SEC did not include this type of ETF in rule 6c-11 and will still require these structures to seek exemptive relief. In Asia, Hong Kong's funds regulator added this share class structure in early 2019.]

Finally, European regulators continue to assess ETF liquidity and interconnectivity of the market participants. Key themes within this area are the risk of contagion, how much attention should regulators pay to the interconnectivity of the ETF ecosystem, and the ability for investors to redeem if there is an event which impacts the secondary market. ETFs are already regulated by a triumvirate of EU legislation: UCITS, MiFID II, and EMIR to some extent. The question now is: are more ETF specific rules needed?

Asia Pacific looks to standardize

Regulators in Asia Pacific are focused on positioning the ETF industry in their respective markets for further growth and scalability. Many of the new enhancements have emphasized the importance of standardization in the market and aligning the region with international best practices.

China

Since the middle of 2018, the onshore ETF market in China has grown rapidly to exceed $70 billion in assets as of the end of November 2019.[1] Even with the recent outsized growth, ETF adoption is still at a nascent stage in China and only accounts for approximately seven percent of total investment fund AUM. But a number of reforms are likely to bring about a shift in assets from the traditional wealth management channels into public funds, with ETFs particularly well positioned to capitalize on this reallocation of assets because of their flexible, transparent, and low-cost structure.

[1] *ETFGI*

Hong Kong

Hong Kong is also spearheading several initiatives focused on enhancing liquidity for ETFs listed in the territory, including launching the Designated Specialist program, which allowed a broader group of global market makers access to provide liquidity for Hong Kong ETFs.

In July, the Hong Kong Exchange (HKEX) launched a pilot program to provide an ETF buy-in exemption for market makers. This program provides these institutions one extra day on top of the standard settlement cycle to cover any short positions resulting from their market making activities. In December, the exchange announced a new ETF-specific spread table, which is scheduled to be introduced in late February 2020. The new spread table, as well as a new set of market making obligations, will align Hong Kong with international standards.

In Hong Kong, expect to see the first ETF issuer take advantage of HKEX being added to the international central securities depository (ICSD) ETF settlement model. This enhancement allows a streamlined settlement process for UCITS ETFs that are cross-listed into Hong Kong, while significantly reducing the risk of settlement failure of the ETF shares.

Issuers are planning to bring a wide range of new products to the market. Supporting product design, the Securities & Futures Commission (SFC) recently announced streamlined eligibility requirements for ETFs adopting a master-feeder structure. This structure allows Hong Kong domiciled ETFs to invest into a single master fund, which would need to be regulated in a recognized jurisdiction, have a minimum asset size of $1 billion, a track record of more than five years, along with other requirements.

Global ETF issuers should watch this development as it could provide an efficient and cost-effective way to enable distribution into Hong Kong and the broader Asian market.

Australia

Transparency is also under the microscope with the funds regulator in Australia (ASIC) pausing approvals of new actively managed ETFs in July 2019 due to concerns related to market making. The review was focused on the internal market making function where the ETF issuer acts in this capacity in Australia. ASIC published their findings in December 2019, including recommendations for compliance, oversight, and ensuring information barriers are in place and functioning properly. ASIC will continue to monitor international ETF developments in these areas and they have re-opened the door for new actively managed ETF listings.

What's next?

2019 was a momentous year for ETF regulation. Rule makers across the globe acknowledged the importance of ETFs to retail and institutional investors alike and brought standardization to much of the global market. 2020 will see many of these rules take effect, with impacts across product development, regulatory compliance, and operations. Further rules may be coming as analysis of liquidity, product structures, and transparency all remain at the forefront of the regulatory agenda.

SEC Zeroes in on Modernization in 2020

The US Securities and Exchange Commission was created in 1934 in the wake of the 1929 Wall Street crash and many of its rules from that period have largely stood the test of time. However, due to significant market changes, the SEC has recently been pushing for modernization. Here's a closer look at the areas they will zero in on in 2020.

ADVERTISING RULES

The SEC's advertising rules have remained largely unchanged since 1961. But in November, proposals to amend the rules received unanimous approval from all five commissioners. The proposals now go through a public comment period prior to implementation, which is set for November 2020.

DERIVATIVES DRAFT RULE 2.0

In late November, the SEC voted to propose amendments to the existing derivatives rule that would establish new criteria for funds to follow when using derivatives. Though the new draft is similar to the SEC's 2015 proposal, there are a handful of critical changes. They're expected to release the final ruleset following and based on the current comment period.

ETF RULES

In September, the SEC passed perhaps one of the most anticipated ETF regulations to date: the so-called "ETF Rule." The ETF Rule (formally known as Rule 6c-11) represents a seismic shift for both incumbent and prospective ETF issuers, with impacts spanning much of the ETF ecosystem. In another boost to the industry, in December the regulator for the first time approved a new wave of semi-transparent active ETFs.

REGULATION BEST INTEREST

Taking effect in June 2020, Regulation Best Interest requires broker-dealers to only recommend financial products to their customers that are in their customers best interests and to clearly identify any potential conflicts of interest or financial incentives they may have with those products.

UPDATED CUSTODY RULE

In recent years, the SEC has felt compelled to release a plethora of FAQs on the "Custody Rule" (Rule 206(4)-2) to address market innovations that are not adequately addressed in the existing ruleset. These innovations range from new asset classes like crypto-assets and non-delivery versus payment (DVP) securities, to the types of entities who may act as qualified custodians. Rather than continue this dynamic alignment process forever, similar to ETFs, it is highly likely that the SEC will look to revamp the rule entirely to address these topics.

PROXY VOTING RULES

The proposed proxy voting changes are now subject to a public comment period which remains open for 60 days from publication. That means interested parties have until mid-January 2020 to submit comments, and it appears that a vocal and robust public debate on the various changes will ensue.

"ACCREDITED INVESTOR" REDEFINED

The definition of "Accredited Investor" has remained unchanged since 1933, but we expect 2020 to be the year that changes. The updates will likely aim to allow "retail" investors greater access to hedge funds, private equity, and venture capital funds. This is a big growth opportunity for US alternatives, but there has been some push back in the industry by those who don't believe retail investors should be allowed to invest in risky and less liquid asset classes, partially for their own protection.

The Asset Manager's Perspective on 2020

Gareth Murphy,
Chief Risk Officer
Standard Life Aberdeen

Christine Brentani,
Regulatory Development and Relationship Manager
Standard Life Aberdeen

Gareth Murphy, Chief Risk Officer, and Christine Brentani, Regulatory Developments and Relationship Manager at Standard Life Aberdeen, highlight the key issues and trends shaping the global regulatory landscape in 2020. They sat down with BBH's Adrian Whelan to discuss regulatory priorities for asset managers in the year ahead.

Adrian Whelan: After a decade of new regulations, it seems like we're entering a period of refinement and improvement. Do you feel the regulatory framework now works as intended?

Gareth Murphy: It's fair to say that there was a huge volume of new regulations produced at quite a fast pace over the last decade or so. Major regulations such as the European Market Infrastructure Regulation (EMIR), the Alternative Investment Fund Managers Directive (AIFMD), the second Markets in Financial Instruments Directive (MIFID II), the fourth Capital Markets Directive and Regulation (CRD IV), and the review of the European Supervisory Authorities (ESAs) means that there is now some tidying up to be done of these regulations. We are in a period where it is appropriate to revisit and refine those rules.

The implementation and embedding of these regulations have created challenges for all stakeholders. The ESAs and national regulators have substantial remits but have limited resources. Asset managers have had to allocate significant resources on implementing complex rule books and ensuring compliance with them. One particular point that warrants mention is the collection of regulatory data across the vast body of financial regulation which is not well joined up and, in my opinion, may be a major source of operational and compliance risk for financial services firms.

Christine Brentani: The amendments to ESMA's founding regulations will have an impact on its governance, organizational structure, and mission from 2020. ESMA will take on increased responsibilities in terms of direct supervision, investor protection, and other goals which will impact its governance, organizational structure, and mission and we will have to see what this means for impacts on firms.

When regulators implement regulations differently in different jurisdictions, it can pose challenges for firms running global business models. Firms would generally prefer a level playing field approach by regulators in terms of implementation of the same regulations across the globe. This allows for less costly implementation and managing of regulations across the business. It would be beneficial for firms if regulators could better align rules globally as they review, assess, and tweak the rules which have already been implemented.

What do you think will be the biggest regulatory issue for asset managers in 2020?

GM: Interesting question! But I would say there is more than one big regulatory issue for this year such as the implications of Brexit for financial services, the development of more demanding requirements around operational resilience, and the setting of higher standards of senior executive accountability. On the third point, the UK is well down this path and other European countries are following in their own ways.

CB: Two other regulatory initiatives that asset managers will be working on include roll-out of the EU (and domestic) sustainability agendas and LIBOR transition.

Do you think we'll at any point see a period of deregulation?

GM: Not in this life – maybe the next!

Actually, I see three things happening in parallel. First, old rules will be tidied up — but slowly. Second, new rules will come in, but I am not sure whether they will be written better than the old rules. And third, supervisory approaches will become more demanding.

CB: It will also be interesting to see how regulators use new technology (regtech and fintech) solutions for the analysis of the vast amounts of regulatory data they are currently collecting. What effect will this have on their current approach to supervision? Will they be able to do more with less? Beyond their own use of new technology, regulators, now more than ever, must be knowledgeable about nascent technology as they are often tasked with deciding whether to regulate it or not.

We have also recently seen the genesis of regulatory sandboxes globally. These allow firms to test products and services in a controlled environment. Again, it is not just industry participants that are evolving to take into account new complex technological dynamics; regulators are too.

There was a global focus on fund liquidity in 2019. Where does this debate go in 2020?

GM: It continues. It is instructive to look back at the much-publicized ESMA Liquidity Stress Testing Guidelines from 2019. Embedded within the guidelines are expectations of how "open" certain funds should be and how liquidity should be managed and reported. These expectations remain at the forefront of the debate.

An increase in market volatility leading to reduced liquidity or difficulty in pricing, similar to what happened in 2008-2009, could expose weaknesses in some funds and may even stress the authorized participant model (AP) that supports exchange traded funds (ETFs). Should pronounced volatility reappear this year we can anticipate liquidity will be front and center once again.

CB: I'll add that the UK has also issued new rules recently for illiquid assets in open-ended funds which ensures the focus on liquidity will continue throughout 2020.

ESMA always has a robust regulatory change agenda. What are the key issues to look out for in 2020?

GM: The approach to assessing the UK as equivalent across regulations such as MiFID II, EMIR, and AIFMD will be critical. Another key issue will be the impact of Brexit on third-country (non-UK) relationships, especially in the area of delegation. Also, as I mentioned, we should expect to see further initiatives in relation to supervisory convergence achieved through ESMA using its newly minted powers more fully.

CB: ESMA has already published its 2020 annual work plan stating that its key priorities are supervisory convergence, risk assessment, single rulebook, and direct supervision.

Beyond ESMA, sustainable investing and the integration of environmental, social, and governance (ESG) considerations into investment decision-making, the MiFID advice process, and firms' operating models will continue to be significant areas for policymakers. The development of a regulatory framework by EU policy makers to support ESG has posed some challenges. Lack of relevant ESG data remains a fundamental concern for asset managers when it comes to the implementation of recently adopted regulation on disclosure and the EU taxonomy to determine whether an economic activity can be deemed sustainable. In addition, some of the detailed requirements on sustainability-related disclosure and changes to the operating models of UCITS Mancos, AIFMs, or the MiFID advice process still need to be finalized by EU legislators. Asset managers, in turn, will need to have sight of the expected rules sooner rather than later to manage the challenge of a rather tight timeline for application.

The EU Commission must consider issues to do with the taxonomy definitions, time periods for implementation, and consistency of approach across all regulations (e.g.: MiFID II, UCITS, AIFMD). Firms will be poised to see how they can implement these new rules as an opportunity for their clients. The challenges of implementation apart, the new rules should provide an important mechanism to bring more transparency into the ESG market and ensure clients are better informed about the sustainability-related risks of their investments, as well the actual impact of products marketed as sustainable.

The positions expressed are those of the authors as of 12/19/19 and may or may not be consistent with the views of Brown Brothers Harriman & Co. and its subsidiaries and affiliates ("BBH"), and are intended for informational purposes only. Information contained herein is based upon various sources believed to be reliable and subject to change without notice.

EU Regulations: How Asset Managers Can Keep an Eye on the Ball

By: John Siena

Global asset managers have become accustomed to navigating the perilous shoals of cross-border regulation, but new regulatory developments in the EU in 2020 may make some unexpected waves.

The EMIR riptide

A major change that took effect in 2019 under the European Market Infrastructure Regulation (EMIR) was the EMIR Refit, which among other things reclassified all AIFMs – wherever located – who manage EU-domiciled alternative investment funds (AIFs) as "financial counterparties" and non-EU AIFMs managing non-EU AIFs as "third-country entity" financial counterparties, subject to reduced burdens compared to those AIFMs operating within the EU.

Just as AIFMs have come to terms with these changes, new considerations and developments continue pull them back to sea.

With the UK's imminent withdrawal from the EU, questions remain about how the EMIR requirements will be incorporated into UK law post-Brexit. It is likely that the UK will be considered a "third country" under EMIR, meaning EMIR will no longer apply directly in the UK following the transition period. Although the UK already agreed to compliance with EMIR in its EU withdrawal documents and UK Treasury regulations reflect this approach.

In any case, trades between a UK entity and an EU entity will still need to comply with the collateral exchange and clearing provisions of EMIR. However, central counterparties (CCPs) in the UK may no longer be presumed eligible to clear trades for EMIR purposes once the UK becomes a third country. In this case, much depends on how the EU treats the UK as "equivalent" — the devil will be in the details and there may be unanticipated effects. For example, even if equivalence decisions under EMIR are made regarding the UK, managers in the US who are subject to EMIR requirements will need to consider whether UK CCPs will be treated as equivalent by non-EU (e.g., US) regulators. Currently, the US Commodity Futures Trading Commission treats EU CCPs as equivalent for US purposes, but once the UK leaves the EU, whether it will continue to do so remains to be seen.

Another major development taking effect under EMIR in 2020 — and having particular effect on investment managers — is what used to be referred to as Phase 5 of the implementation of initial margin (IM) requirements for OTC derivatives.

In recognition of the broad state of unpreparedness of impacted sectors, regulators announced in September 2019 they were putting in place a revised timetable for the "final" phase, dividing Phase 5 in two and thereby providing smaller market participants with additional time to prepare by pushing back their compliance date to the new Phase 6 in 2021.

Firms with an aggregate average notional amount (AANA) of more than $50 billion will need to comply with the rules by September 2020 (revised Phase 5) and an estimated several hundred smaller investment management firms and regional banks with an AANA of more than $8 billion will be required to comply by September 2021 (new Phase 6).

Once a firm is determined to be in scope, market participants must carry out several steps ahead of the compliance deadline. These include engaging with counterparties in order to confirm scope of the impact, including which legal entities are covered, putting in place agreements confirming how IM is to be calculated, agree eligible collateral and haircuts with each counterparty and with third-party custodians or tri-party collateral agents. The length of time and complexity for putting necessary arrangements in place should not be underestimated.

AIFMD and UCITS: Keeping the records straight

A less obvious development potentially impacting investment managers is a change being made to the bookkeeping and records requirements for depositaries of AIFs and UCITS funds. 2018 amendments to both AIFMD and the UCITS Directive — which take effect April 2020 — will require depositaries to maintain their own sets of books and records that are "independent" of any sub-custodians to whom they delegate "custody" of the investment fund's assets. Such "delegates" typically include prime brokers and collateral agents.

> “
> *Currently, the US Commodity Futures Trading Commission treats EU CCPs as equivalent for US purposes, but once the UK leaves the EU, whether it will continue to do so remains to be seen.*

While some depositaries (depending on jurisdiction and local practice) may already comply with these requirements, some may not. Local regulators historically have varied in their approach to this issue, but the 2018 amendments are intended to foster harmonization across all EU member states. The industry in some countries is still waiting to see how their local regulator will implement the revised rules. Any meaningful deviation from a harmonized approach may trigger intervention by the European Securities and Markets Authority (ESMA), who is charged with preventing divergence by member states.

Here, too, the devil will be in the details: if requirements are imposed in a way that is too stringent, or that requires depositaries to effectively intervene in the process flow between buy-side investment managers, prime brokers, and collateral agents, investment managers may find that the arrangements they have established will become more complicated. The custodian industry has sought to ensure this does not happen while still demonstrating an "independent" view of investment fund positions as an added measure to protect investors against risks to fund assets.

Brexit redux

Another concern worth watching in 2020 is the fallout from a likely final Brexit decision by the UK in January on fund managers based outside the EU. We mentioned potential indirect impacts on clearing arrangements but, more fundamentally, the European Commission has made clear that it will not be "business as usual" for fund management firms operating in London and hoping to do business in the European Economic Area.

Many fund management firms already have transferred staff from London to places like Dublin, Frankfurt, and Paris. What is still up in the air are the so-called substance requirements needed to be considered an EU-based fund. Individual member states – such as the Luxembourg CSSF – have provided clarity regarding requirements for local management and operations but other jurisdictions have been less clear on this aspect. Meanwhile, ongoing post-Brexit transition discussions between the EU and the UK will likely determine whether some form of mutual equivalence can minimize disruption for fund managers. If negotiations do not go well, UK-based fund managers may need to restructure further or find alternative means of access to the EU market (with EU managers possibly facing similar barriers by the UK).

Long Range Regulation: The Global Reach of SM&CR

By: Jamie Dickson

In the aftermath of the financial crisis, regulators globally recognized a need to reduce risks by ensuring that firms set rules of behavior for their staff and monitored their actions on a regular basis. The UK introduced some of the strictest standards of conduct in late 2019, with full implementation taking place in 2020. Regulators in other jurisdictions, such as Ireland and Singapore, are likely following suit soon.

The UK's program, known as the Senior Managers and Certification Regime (SM&CR), is an evolution of the previous monitoring program, the Approved Persons regime. SM&CR has applied to banks since 2016 but will now impact firms solely regulated by the Financial Conduct Authority (FCA), including most asset managers.

The SM&CR's global reach

While the FCA is based in the UK, key aspects of the new rules can apply to senior managers in other countries when they are responsible for business operations of their UK firm. As a result, senior managers of US or Asian firms with UK subsidiaries need to be aware of their responsibilities under the regime.

SM&CR rules came into force for investment managers on December 9, 2019, but this will be followed by a one-year transition period to train staff that are not senior managers or certified staff and assess certification personnel for their suitability.

The conduct rules will apply to senior managers and what are deemed certification staff — people who are not senior managers but whose jobs could have a significant impact on customers, markets, or the firm. The rules will also apply to all other employees other than those who do not perform a role specific to financial services.

The SM&CR places asset managers and other firms solely regulated by the FCA in one of three buckets:

- Enhanced — the largest and most complicated firms
- Core — the majority of firms
- Limited Scope— which will have fewer requirements than core

The FCA has published a guide to SM&CR that explains how to determine which category your firm is in, and what the differences are in requirements.

Under the new rules, firms will have to ensure that every affected area of their

business has a senior manager responsible for that activity, that senior managers have a "statement of responsibilities" that states what each senior manager's responsibilities are, as well as a duty of responsibility, meaning that they have to take reasonable steps to avoid a violation of the rules or they could be held accountable by the FCA. Significantly, there is no territorial limitation for enhanced firms. So, a senior manager in New York who oversees a business area in London could be subject to these rules.

A senior manager's responsibility also extends to any third-parties the firm uses for things like back office functions. Managers must be able to demonstrate that they are overseeing the outsourced function through such steps as collecting data and conducting on-site due diligence visits and cannot assert pure reliance on the third-party firm as a defense to breach.

For employees below senior manager level, but who hold so-called certification functions, such as traders who could cause harm to customers, the firm, or markets, the firm is required to assess their performance on an annual basis and "certify" that the employee is "fit and proper" to perform the function.

In the current transition period, firms are required to train their employees on how conduct rules — like acting with integrity — apply to their specific job functions. There also are specific rules of conduct for senior management functions.

What the SM&CR rules require

The new rules are expected to have a major impact on human resources departments at covered firms. When a new senior manager or certified employee is hired, for example, the firm is required to request a regulatory reference from every firm the person has worked for in the past six years. While this will become standard practice in UK financial firms, it could be problematic if the employee did not work in financial services previously or worked in another country. The FCA has said firms must take sufficient steps in their due diligence process in this regard. However, if a reference is not forthcoming despite these efforts, a record of emailed and telephoned requests could be used to document due diligence with regard to this requirement.

Disciplinary cases that relate to a breach of the conduct rules also must meet specific FCA requirements. Firms have seven days following the conclusion of a disciplinary process to notify the FCA if it resulted in disciplinary action against a senior manager such as dismissal, a reduction in pay or a claw-back of bonuses, or if the senior manager received a written warning about a breach of the conduct rules. For other employees that fall under the scope of the conduct rules, the firm need only to submit a report of conduct breaches once a year. Importantly, the conduct rules are not limited to the financial operations of the firm — a breach can occur for sexual harassment or poor behavior in the office.

In perhaps a good sign but unintended consequence, during implementation over the past three years, some firms actually filed too many regulatory reports about minor infractions. Applying best practice in relation to disciplinary issues, as set out by the Advisory, Conciliation and Arbitration Service (Acas), and making informed and educated determinations regarding reportable disciplinary cases, will ensure these new rules will bring about the intended results without unnecessary personal and professional consequences. The FCA is creating a register of employees, which will allow firms to quickly review and verify any senior management or certification functions, as well as positions under the previous regime, held by potential hires in their past and any regulatory sanctions or prohibitions issued against them.

The FCA is making clear that these new rules are an evolution, not a revolution. Some banks spent vast sums overhauling their HR systems, which later proved not to be the most effective approach. The important thing is to consistently update your firm's knowledge about what is required, including any relevant feedback from the industry and regulators, and which employees will be specifically affected.

AMLD Continues to Sharpen Its Focus

By: Eimear Hennigan and Laura Murray

One area where global regulators have been consistently raising the bar for asset managers is legislation to prevent money laundering and terrorist financing. In Europe, those efforts in 2020 will be primarily focused on clearly identifying certain beneficial ownership of investments and making sure that investors in EU prescribed countries are subject to extra scrutiny.

A major step in the crackdown was the adoption of the fourth EU anti-money laundering directive, known as AMLD 4, in 2015. The directive required managers in the EU to establish the ultimate beneficial owners (UBOs) of UCITS and AIF funds and called for the establishment of a registry of beneficial ownership that could be accessed by security authorities. With the adoption of AMLD 5 in July 2018, the regulations have been tightened even further, with the UBO registry becoming public in most cases. Member states were given 18 months to implement the latest AML directive, and the deadline for enabling legislation to be in place was January 10, 2020.

Identifying beneficial ownership

The EU above all other global policymakers have been most focused in requiring disclosure of beneficial ownership information relating to financial accounts. Not only is each country to set up a registry of beneficial ownership, but the EU is establishing a central registry for all 28 members (though whether the UK will participate after Brexit is an open question.) While the obligation to consult UBOs starts in 2020, the central registry for companies is to be up and running by March 2021.

According to the revised law, individuals who own more than 25 percent of a company are considered beneficial owners and must be identified. The law also provides for identification of the beneficiaries of a trust and controlling figures of a foundation. Trusts are more common in Luxembourg, where investments are more complex and more real estate focused.

When the beneficial owner of a company can't be properly identified, fund managers "having exhausted all other means of identification, and provided there are no grounds for suspicion, may consider the senior managing official(s) to be the beneficial owners," ALMD 4 says.

The senior manager rule has also been implemented in Luxembourg and Ireland where many UCITS funds are registered. What that means for asset managers is they have to verify the senior managing official (SMO) of certain entity types and in some cases, validate the information provided by the investor. It will require looking through the company structure and validating what they have been told. Ongoing customer due diligence reviews will help monitor the accuracy and veracity of entries to these registrars.

The directives also specify that managers must carry out enhanced due diligence on certain corporate customers. They include corporates operating with nominee shareholders, where the beneficial owners are not clearly identified, and investors from 16 countries which have been identified by the EU as having deficient anti-money laundering rules in place. The higher degree of due

diligence usually involves obtaining information about the source of funds for each investment being made by the higher-risk customer. Luxembourg allows nominee shareholding but also asks managers to request nominee shareholders to provide information on the UBO.

Another consideration for managers is the sharing of data about UBOs obtained as part of their anti-money laundering requirements. Under separate legislation called the Common Reporting Standard, European governments have agreed to provide information about financial accounts to tax authorities in other states who have adopted the rule.

Across each new version of AMLD, regulators continue to stress the importance of AML governance. This means firms need to:

- Understand their roles and responsibilities (and where they can delegate work but retain responsibility to third-party providers)
- Instill well documented policies and procedures around AML
- Provide proper employee training and support

AMLD 5, 6, and beyond

After AMLD 4 was adopted, the EU also adopted a regulation on preserving the security of data for individuals in the 28 member states. Managers have to ensure that data is deleted after five years and that their sharing of information related to AMLD is compliant with the data regulation.

While managers are still working to implement AMLD 5, the EU also adopted AMLD 6 in December 2018, which will come into force in December 2020. The directive is aimed mainly at harmonizing laws in member states on money laundering and definitions of money laundering crimes. But AMLD 6 also introduces a relatively new concept of "failure to prevent money laundering," which could expand the legal scope of money laundering prosecutions and require managers to take additional due diligence steps.

Interestingly, the UK has said it will opt out of AMLD 6 on the grounds that domestic legislation is already largely compliant with the directive. "The Government decided not to opt in as we did not consider that opting in would enhance the UK approach to tackling money laundering," it said. But the decision raises a larger debate about Brexit: will the UK stay equivalent with European regulation on money laundering or diverge? If the UK diverges, it could become more difficult for UK firms to gain access to European capital markets. Ireland also has the option to opt-out, but it is unclear at this time if this will occur.

The EU continues to assess the AML regulatory landscape with some calling to retire the AML directives in lieu of direct regulation (similar to GDPR). Plans are also at advanced stages at the European Commission to create a supra-national AML regulator (with extra-territorial powers) under the authority of the European Banking Authority (EBA).

2020 REGULATORY FIELD GUIDE

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