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Global Fund Management Regulatory Outlook 2022

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Executive Summary

There is no doubt that the three letters that have cropped up more often than any others in financial services regulation over the last couple of years have been E, S and G, and we don't see this situation changing at all in 2022.

Progress has been made in many countries on developing the frameworks for companies, asset managers and asset owners to report their ESG credentials, but the journey has only just started. As well as the direct impact of reporting on ESG, the theme has also spread its tentacles into many other existing areas of regulation, with ESG/sustainability considerations being included in MiFID II, the UCITS Directive, the Alternative Investment Fund Managers Directive (AIFMD) and others.

But ESG isn't the only game in town.

Following the end of the Brexit transition period, the UK has started to assert its independence from the EU legislations that it on-shored in bulk (while acknowledging that many businesses have activities on both sides of the English Channel).

The EU has also continued to develop its own rulebooks on matters unrelated to ESG, including the heavily criticised PRIIPs Key Information Documents (KIDs).

Elsewhere ESG also dominates, but in Australia they have also had their hands full with the introduction of the Design and Distribution Obligations (DDO) in October.

In this white paper, the examples of proposed ESG disclosures in Hong Kong and DDO in Australia show how global all regulatory change has become. Wherever changes may originate, it is clear that if they are relevant elsewhere they will soon be exported, particularly in the area of transparency and increased disclosure to retail consumers.

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Evolving ESG Governance and Disclosures

Europe

At the heart of the EU's ESG disclosure regime are two pieces of legislation,

- the Taxonomy Regulation, and
- the Sustainable Finance Disclosure Regulation (SFDR).

The former is a classification system that determines whether an economic activity is regarded as sustainable and consistent with any of six environmental objectives, while the latter sets out the disclosure requirements for funds, fund groups and financial advisers.

	EU ESG Disclosure Regime	
Regulation	Taxonomy Regulation	Sustainable Finance Disclosure Regulation (SFDR)
What	A classification system for sustainable economic activities for investment purposes	Sets out disclosure requirements for financial market participants
Why	To support companies in the transition to climate neutrality and a sustainable economy To establish a common language around green activities and a frame of reference for investors and companies To help mitigate market fragmentation To protect against greenwashing	To provide more transparency on sustainability within financial markets To standardise disclosure requirements To prevent greenwashing and comparability
Who	Financial institutions that offer financial products to the European market Non-financial companies that fall within the scope of the Non-Financial Reporting Directive (NFRD)	Financial market particpants (e.g. Asset managers) Financial advisers
When	1 January 2022	10 March 2021 – Level 1 1 January 2023 – Level 2

Sustainable Finance Disclosure Regulation (SFDR)

The SFDR sets out ESG disclosure rules for fund groups, pension providers, discretionary fund managers, financial advisers and other financial services organisations with operations across the European Union. These disclosures need to be pre-contractual and shown in the prospectus and on the website, and then need to be reviewed periodically thereafter in the annual report.

The SFDR is all about transparency, requiring fund groups to disclose how they consider the principal adverse impacts of investment decisions on sustainability factors – and if they don't do this, to explain why not.

How is SFDR linked to the EU Taxonomy?

The SFDR requirements are linked with those under the EU Taxonomy by including 'environmentally sustainable economic activities' as defined by the Taxonomy Regulation in the definition of 'sustainable investments' in the SFDR.

At a product level, traditional (non-ESG) funds also need to explain how they integrate sustainability risks into their investment decisions or, if they don't, to explain why not. The disclosure requirements for ESG funds depend on whether they promote environmental or social characteristics or whether they have sustainable investment as an objective, with those coming under this latter category often known as impact funds.

Although the SFDR is not about classification, the industry has adopted it as a labelling scheme, with traditional funds being classified as "Article 6", those that promote environmental or social characteristics as "Article 8", and those with sustainable investment as an objective as "Article 9". On the assumption that investors, when asked, will want at least a degree of sustainability in their portfolio, there has been a drive towards funds being classified as Article 8 or 9, which has in turn led to a backlash from a number of regulators, highlighting a mismatch between what is said and what is done, and also raising concerns about greenwashing.

Article 6 funds	Article 8 funds	Article 9 funds
funds which are not promoted as having ESG factors or objectives	funds that promote ESG characteristics but do not have it as the overarching objective	funds which specifically have sustainable goals as their objective

Regulatory Technical Standards (RTS)

Given the complexities involved in designing a reporting system from scratch for a topic as broad as sustainability, it is no real surprise that its implementation has not gone as smoothly as planned.

The original regulation was passed at the end of 2019, with a launch date of 10 March 2021. However, as is the way with EU regulations, the Level 1 Regulation was supplemented by a Level 2 Regulation, known as the Regulatory Technical Standards (RTS), which provide the details of exactly what needs to be disclosed, as well as where and when it needs to be disclosed, what templates to use, and so on.

Due to the detail in the RTS and the time it would take the European Commission to scrutinise them before adopting them, it was agreed that it would be impossible to meet the 10 March 2021 deadline. However, it was also decided that it would give out the wrong signals if the disclosure under the SFDR was delayed, so the compromise was to continue with the requirements under the Level 1 Regulation from 10 March without the detailed instructions in the RTS, and to add them later.

It was initially decided to incorporate the RTS from 1 January 2022, but this date was later deferred to 1 July 2022, and finally now to 1 January 2023. So until then, groups will need to publish both entity-level and product-level statements on their website without any standardised templates or detailed instructions on what to disclose.

Once the templates in the RTS are live, providers will need to publish a statement on their website of the "principal adverse sustainability impacts" of their investee companies using those templates. These include a wide range of mandatory indicators on environmental issues, such as: greenhouse gas emissions; fossil fuel and non-renewable energy use; hazardous waste; and social and employee issues, including the gender pay gap and exposure to controversial weapons.

Additional environmental indicators include investments in companies emitting ozone-depleting substances, or those involved in chemical production or deforestation. Further social indicators include lacking policies on human trafficking, child labour or discrimination. The European ESG Template (EET) is also relevant because funds that invest in other funds will need all of the detailed information disclosed by the underlying funds before they can produce their own reports.

But more than that, financial advisers will also need to publish their own adverse sustainability impact statements. If applicable, these will need to explain which factors from the providers' statements they take into account when assessing suitable funds, and in what order of priority.

Taxonomy

The ESG Taxonomy Regulation was passed in June 2020 to supplement the SFDR by setting out a classification system for economic activities in a wide range of industries to determine whether they are sustainable.

The Taxonomy Regulation set out six specific environmental objectives under which each activity would be considered:

- climate change mitigation
- climate change adaptation
- the sustainable use and protection of water and marine resources
- the transition to a circular economy
- pollution prevention and control
- the protection and restoration of biodiversity and ecosystems

To be deemed sustainable, an activity must not only contribute to one or more of these objectives, but also must not significantly harm any of the others.

To date, the delegated act has been submitted to the European Parliament, with annexes running to a total of 488 pages covering the two climate change objectives. Four further annexes are due in 2022 for the other objectives.

From 2022, companies will need to include information on the extent to which their activities qualify as being environmentally sustainable in accordance with those first two objectives in their annual reports. This obligation is expected to be broadened out to the other objectives a year later.

In October 2021, the European Supervisory Authorities (ESAs) published the RTS for the Taxonomy Regulation, with changes to the templates in the SFDR RTS. To avoid any danger of contradiction between the two sets of RTS, it was determined that they would be combined into a single consolidated document, which was then submitted to the European Commission for adoption.

At the time of publication the Commission deferred the date of application of the bundled RTS' to 1 January 2023.

The European ESG Template (EET)

The industry-led European Working Group (now known as FinDatEx) has done fantastic work over several years to develop templates that the fund and structured product industries across Europe have adopted, so that those who produce regulatory data can disseminate it to those who need to disclose it.

Earlier this year FinDatEx started work on an ambitious and challenging project, the European ESG Template (or EET), with a current target date of 1 July 2022 (at the time of writing) which is also when the Regulatory Technical Standards (RTS) for the SFDR were due to take effect. This has relevance for UK-based groups that have operations in the EEA, or that have set up funds in Europe which mirror those in their UK range in order to cater for Europe-based investors post-Brexit.

Advisers will also want more information than is on the European MiFID Template (EMT) when they need to ask their clients whether they wish to incorporate sustainability factors in their investments. With clients likely to have a whole range of different priorities they will want to focus on, the details in the EET will be a way of seeing how well funds are doing against their criteria.

FinDatEx is working on distilling all the data requirements into what needs to be disseminated by fund providers to distributors and advisers by way of the EET. A lot of work is being put into getting ready for this, and the latest expectation is for the first working version of the EET to be ready by early 2022, with a fully tested version available for data transfer by May 2022.

There is a huge amount of data to be gathered on underlying investee companies, and nobody realistically expects to have a majority of the data until at least the first couple of years have gone by. But the plan is to report as much as possible, so the EET will be invaluable in getting whatever data there is out to those who will need it.

From 2022, companies will need to include information on the extent to which their activities qualify as being environmentally sustainable in accordance with those first two objectives in their annual reports. This obligation is expected to be broadened out to the other objectives a year later.

United Kingdom

Alignment with the Task Force on Climate Related Financial Disclosures (TCFD)

The UK has taken full licence to pursue its own regulatory path since the end of the Brexit transition period on 31 December 2020. The UK government has stated its commitment to "match the ambitions" of the SFDR, while also publicising its commitment to align itself with the Task Force on Climate-Related Financial Disclosures (TCFD).

The TCFD recommendations concentrate solely on the E in ESG investing, and the FCA has stated that its new ESG Sourcebook "will expand over time to include new rules and guidance on other climate-related and wider ESG topics".

Based on its consultation, which closed in September, the FCA is sticking to its usual approach of principles-based regulation, rather than the EU's preferred rules-based approach that sets out every box that needs to be ticked. As the FCA says, it aims to enable investors to make considered choices while also being proportionate, as the requirements will apply to asset managers and asset owners with over £5bn AUM/AUA, which the FCA estimates to cover 98% of assets managed or held in the UK.

Similar to the SFDR requirements, the FCA has set out disclosures at the entity level and product/fund level, both of which must be posted on the company website. Product-level disclosures must also be included in "appropriate" client communications, which could be the annual report, annual pension statement or another periodic or on-demand client report.

At the entity level, firms will need to report how they take climate-related risks and opportunities into account on behalf of their client assets, including governance, strategy, risk management, metrics and targets.

Product-level disclosure consists of a baseline set of mandatory carbon emission and carbon intensity metrics, and any governance, strategy or risk measures that differ from the entity-level disclosure. Both levels must also undertake scenario analysis.

Metrics

The metrics and targets are expected to be consistent with the "net zero by 2050" target, and the consultation paper noted the metrics and targets set out by the TCFD. Firms must describe the target they set themselves, including any KPIs they use to measure progress against the TCFD report. Any firms that haven't set out climate-related targets will need to explain why not.

Product-level metrics include the core metrics of greenhouse gas emissions, total carbon emissions, the carbon footprint and weighted average carbon intensity, and the consultation paper sets out methodologies for some of these while also acknowledging the possible difficulty with data availability.

Timeline

Implementation of the FCA's plans will be phased, with asset managers of over £50bn and asset owners with over £25bn being caught in the first phase starting on 1 January 2022, with the first publication deadline being 30 June 2023. The second phase, for smaller firms with over £5bn of assets, comes in on 1 January 2023, with reporting due by 30 June 2024.

In addition to these reporting requirements, firms must carry out regular scenario analysis at both entity and product level to test their portfolios against different climate issues.

Discussion Paper 21/4 on Sustainability Disclosure Requirements (SDR) and Investment Labels

In November 2021, the FCA published its discussion paper on the requirements for listed companies, asset managers and asset owners to disclose their sustainability risks, opportunities and impacts. The paper also outlined plans for a UK Green Taxonomy – expected to closely resemble the EU Taxonomy, as the UK played an active part in developing that – and a system of sustainable product labels.
The discussion paper is open for comments until January 2022 and will be followed by a consultation paper before final rules are issued.

Climate Reporting Obligations for Pensions

The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 came into effect on 1 October for schemes with over £5bn of assets. Schemes with between £1bn and £5bn need to comply from 1 October 2022. Reports need to be issued within seven months after the end of the scheme year, with the first one relating to the scheme year ending after each of these dates.

The reporting requirements follow much the same path as the FCA's proposals for asset managers and asset owners, in that they must identify climate-related risks and opportunities likely to affect the scheme's investment strategy over the short, medium and long term.

Trustees also need to assess and disclose the potential impacts and resilience of their scheme's assets in at least two climate scenarios, one of which is based on a temperature rise of between 1.5°C and 2°C (in line with the goals of the Paris Agreement). This scenario analysis may be qualitative and/or quantitative.

Hong Kong

Code on Unit Trusts and Mutual Funds, and changes to the Fund Manager Code of Conduct for ESG disclosures

The Securities and Futures Commission (SFC) has published two documents relating to ESG funds and the management and disclosure of climate-related risks.

In June 2021, the SFC issued a circular to fund management companies, setting out that ESG funds – i.e. those that incorporate ESG factors as their key investment focus and reflect this in their investment objectives and/or strategy – should not overemphasise their ESG features in marketing and other material. Accordingly, non-ESG funds must not imply any ESG element in their name or elsewhere.

The circular also contains information on the use of benchmarks by ESG funds, the description of their risks, and the due diligence they must undertake on the investments they make.

The circular states that ESG funds should conduct assessments of the progress they have made on their ESG focus on at least an annual basis, including how much of the fund is invested in line with the ESG aims, how the fund has performed against its ESG benchmark, and any specific actions taken to attain its ESG focus (such as its proxy voting record, engagement activities, etc.). In August, the SFC published its conclusions following its consultation into the disclosure of climate-related risks. The route taken has been very similar to that taken by the FCA in the UK, as the SFC has focused on the TCFD recommendations and has

stuck to principles-based regulation. Just as the FCA has done, the SFC has also said it “will remain abreast of international and market developments and explore expanding regulatory coverage to other aspects of ESG over the longer term”.

The disclosure requirements have been broken down in three ways. Firstly, at a Baseline and Enhanced level; secondly, at an entity and fund level; and finally for Large Fund Managers (i.e. those with AUM over HK$8bn/US$1bn) and the rest. At a Baseline level, there are governance requirements related to the roles, responsibilities and procedures at board and management level. There is also a requirement within investment management to identify, assess and factor in climate-related risks unless they are deemed irrelevant for certain strategies or funds (in which case this should be disclosed and records kept).

Then there are risk management requirements. Groups must ensure appropriate steps are taken to identify, assess, manage and monitor material climate-related risks.

Large Fund Managers, which are required to meet Enhanced requirements, must assess the usefulness of scenario analysis to evaluate the resilience of funds and strategies to climate-related risks under different scenarios and – if deemed useful – carry out that scenario analysis. Where data is available or can be estimated, they must also identify the portfolio carbon footprint of the Scope 1 and Scope 2 GHG emissions of the underlying investments.

	Hong Kong SFC Disclosures
Baseline	All fund groups need to report on Baseline requirements at the entity level. These are: • Disclosure of the governance of climate-related risks at both a board and management level • Disclosure of the process for identifying and managing climate-related risks Where climate-related risks are deemed to be irrelevant at entity level or fund level, this should be disclosed at the appropriate level. Disclosure should be proportionate to the extent to which climate-related risks are taken into account, should be made in writing and should be made available to investors by electronic means, e.g. on the company website.
Enhanced	**Enhanced disclosures only apply to Large Fund Managers.** **Entity level** Disclose the company's engagement policy with investee companies and illustrate how material climate-related risks are managed in practice. **Fund level** Disclose the portfolio carbon footprint of Scope 1 and Scope 2 GHG emissions (where this is available or can be reasonably estimated); indicate the calculation methodology, including any assumptions or limitations; and indicate the proportion of investments included in the calculations.

Large Fund Managers, which are required to meet Enhanced requirements, must assess the usefulness of scenario analysis to evaluate the resilience of funds and strategies to climate-related risks under different scenarios and – if deemed useful – carry out that scenario analysis

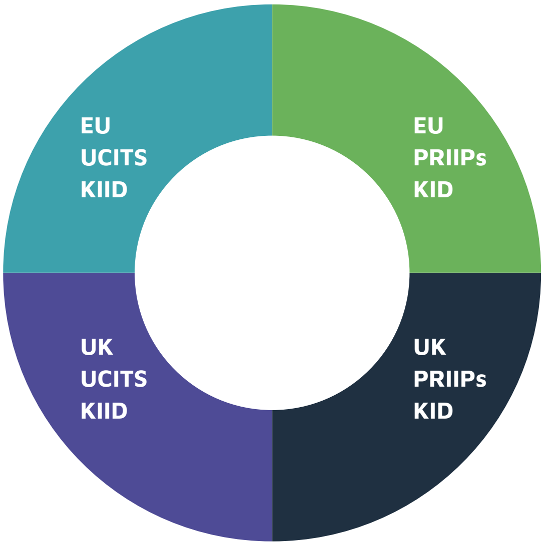
Deadlines

The SFC published its conclusions on 20 August 2021 and set a 12-month transition period (i.e. to 20 August 2022) for Baseline disclosures for Large Fund Managers.

The SFC also set a 15-month transition period (i.e. to 20 November 2022) for Enhanced disclosures for Large Fund Managers and for Baseline disclosures for other groups.

The carbon footprint disclosures for Large Fund Managers must be disclosed as at the first fund-year end on or after 20 November 2022, and each year thereafter. This disclosure must be made through a channel the group feels is appropriate, and not later than the usual due date for the fund's annual report and accounts. Disclosures should be reviewed at least annually and updated as necessary, although carbon footprint disclosure may be made more frequently than annually if the group believes this is appropriate.

Transitioning from UCITS KIIDs to PRIIPs KIDs



Europe

On 7 September, the European Commission adopted the revised PRIIPs Regulatory Technical Standards (RTS) and annexes, with an effective date of 1 July 2022.

While these are waiting to be passed into law by the European Parliament and Council, the European Parliament has voted on two further amendments.

The first of these amendments is to Article 32 of the PRIIPs Regulation, extending the end date for the UCITS KIID exemption once again – this time to 31 December 2022 – to give UCITS management companies at least a year to prepare after the adoption of the PRIIPs RTS. The other amendment is to the UCITS Directive, confirming that if a UCITS manager publishes a PRIIPs KID for a retail share class, there is no need to publish a UCITS KIID as well. All other requirements in the UCITS Directive, such as the need to translate the document and lodge it with regulators, will continue to stand.

Two other points have also been confirmed by these amendments.

The original proposal was for the PRIIPs KID changes to coincide with the end of the UCITS KIID exemption, which meant that any references to UCITS KIIDs could be removed from the revised RTS. However, the text supporting the need to coincide has been removed from the latest proposals, so it seems very likely that there will be a six-month period after the PRIIPs KID changes take effect when UCITS KIIDs will still exist.

These amendments also confirm that UCITS management companies will be able to choose whether to publish UCITS KIIDs or PRIIPs KIDs for non-retail share classes, as they fall out of the scope of the PRIIPs Regulation. Earlier pleas for non-retail share classes to be exempted from needing to produce any generic pre-sale document clearly fell on deaf ears, as they will still need to produce one or the other.

Changes to EU PRIIPs KIDs

While the idea of a standard pre-sale disclosure document has been supported in principle since it was first proposed, the content of PRIIPs KIDs has been heavily criticised since even before they went live on 1 January 2018.

The two issues that have received most criticism relate to the performance scenarios – which illustrate what future returns could be, but are based on historical price volatility – and the calculation and presentation of the costs.

To remove the pro-cyclical nature of the performance scenarios, the latest RTS have extended the price history used in the calculation to at least 10 years, in an attempt to capture a greater combination of rising and falling markets. The price history is then divided into a large number of overlapping shorter periods, from which the favourable, moderate and unfavourable scenarios can be derived.

The stress scenario uses an even more complicated set of calculations, and a new rule has been introduced to say that the stress scenario cannot be better than the unfavourable one, something that has been possible for particularly low-volatility funds.

Given how meaningless it is to illustrate possible future returns by using historical prices, three further changes are being introduced to this section:

- The current requirement is to show scenario returns for funds after one year, after the recommended holding period (RHP) and after half the RHP. In future, scenarios will only include one year and the RHP, with half the RHP included if the RHP is 10 years or more.

- Past performance is to be shown for funds, with a similar chart to that currently used for UCITS KIIDs. But, because the PRIIPs Regulation does not allow for its inclusion on the KID, this is to be on a separate document or on the group's website, with signposting from the KID.

- Performance scenarios are to be recalculated at least monthly, with the results available on the group's website and also signposted from the KID.

On costs, the two key changes relate to the presentation of initial charges for funds that still have these, and to transaction costs.

Currently, the annualised impact of the initial charge, spread over the RHP, is shown, but this has understandably caused confusion. In future, the actual initial charge will be shown for funds.

The possibility of negative transaction costs using the slippage methodology has confused investors and irked the regulators, so the latter have simply banned them. In future, transaction costs cannot be less than the explicit costs, i.e. commission, taxes, etc.

Whether these changes silence the complaints about PRIIPs KIDs remains to be seen, but few UCITS managers are looking forward to moving from UCITS KIIDs that have been widely accepted for a decade to the controversial PRIIPs KIDs. And, of course, some may continue to produce UCITS KIIDs for their non-retail share classes and for sales into the UK (more on this below).

Many in the industry had hoped that the replacement of the performance scenarios by "appropriate information on performance" would include past performance for funds

UK vs EU Divergence

The FCA has always been as aware as EU regulators of the criticisms that have dogged PRIIPs KIDs since the beginning.

As a result, a specific section was included in the Financial Services Act 2021 to deal with three areas:

- The FCA was to be given the power to specify exactly what products are in the scope of the PRIIPs Regulation (in the UK). Reference was made to certain corporate bonds, because confusion over this has been seen as contributing to a reduction in issuance since 2018.
- Performance scenarios – the most controversial area of KIDs – would be replaced by "appropriate information on performance".
- HM Treasury would be able to extend the UCITS KIID exemption by up to five years, because "government currently considers that the existing rules for UCITS disclosure are satisfactory".

United Kingdom

The scene was set for the UK to diverge from EU rules on PRIIPs in June 2020, when Chancellor Rishi Sunak said the UK "will…tailor our approach to implementation to ensure that it better suits the UK market outside the EU". No sooner was the Financial Services Act passed than the Treasury announced that UCITS KIIDs would remain in the UK until the end of 2026.

In July 2021 the FCA published a consultation paper on changes to UK PRIIPs KIDs with a proposed live date of 1 January 2022, which was widely regarded as unworkable. To show how fluid regulatory changes can be, the consultation ended on 30 September and the FCA announced shortly afterwards that it would publish its policy statement in the first quarter of 2022, rather than applying the changes from the start of the year. The timetable for implementation will be included in that policy statement.

Many in the industry had hoped that the replacement of the performance scenarios by "appropriate information on performance" would include past performance for funds, as there was nothing to stop the UK from unilaterally amending the Regulation to allow for its inclusion.

Although the consultation paper included a section on what past performance could look like if the FCA were to include it, the proposal was to replace the scenarios with narrative explanations of the key factors that could affect future returns, without including any past performance charts or tables.

Other than that, the proposed changes were limited to minor tweaks, such as requiring providers to increase the Summary Risk Indicator (SRI) score if there was reason to believe that the calculated score would fail to adequately reflect the risks of the PRIIP, and clarification of the way to average transaction costs over three years.

While the FCA unsurprisingly resisted calls to move away from the slippage methodology to calculate transaction costs, the consultation proposed relaxing that in certain instances, such as for index funds and OTC bonds. More controversially, it proposed limiting the effect of anti-dilution mechanisms so they could not lead to negative transaction costs. This is slightly different from the solution adopted for EU PRIIPs but has the same intention, i.e. to avoid the possibility of negative transaction costs that could arise from use of the slippage methodology.

Consequences of UK Divergence from EU PRIIPs

There are several minor, and some not so minor, differences between the information that will be shown on EU and UK PRIIPs KIDs once all the changes come into effect. However, the greatest impact will be from the ongoing existence of UCITS KIIDs in the UK after they are consigned to history in the EU, at least for retail investments.

As PRIIPs KIDs are only required for products available to retail investors, UCITS managers in the EU may opt either to continue to produce UCITS KIIDs or to produce PRIIPs KIDs for their non-retail share classes, so it is possible that they won't completely disappear.

But, as many EU-domiciled UCITS still have passporting rights into the UK under the FCA's Temporary Marketing Permissions Regime, they will need to continue to produce UCITS KIIDs for all share classes marketed in the UK. Not only will this be a logistical headache, but they will need to ensure those UCITS KIIDs can't fall into the hands of retail investors in the EU. This may also help to sway those groups when deciding whether to produce PRIIPs KIDs or UCITS KIIDs for their non-retail share classes, as they will need to maintain systems to produce both.

The greatest impact will be from the ongoing existence of UCITS KIIDs in the UK after they are consigned to history in the EU, at least for retail investments

Implementing DDO – "Australia's MiFID II"

The Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act was passed in April 2019, making it clear that the Australian government was upping its game and matching other countries in increasing the transparency of financial products, reducing their use of jargon and generally making them more consumer friendly.

As the name of the Act makes clear, it placed obligations on the development and governance of financial products (Design), how and to whom those products are sold (Distribution), and, if that doesn't remove the possibility of consumer detriment, the regulator also has powers to stop potential or further harm (Product Intervention).

Usually shortened to the Design and Distribution Obligations (DDO), they set out requirements on product issuers to identify a target market for a wide range of financial products, and on distributors to ensure they only sell those financial products to retail customers in the identified target market.

As with MiFID II in Europe, obligations are also placed on product issuers for standardised disclosure of costs and charges, and for product issuers to take on board feedback from distributors on the number and nature of complaints, or if products are sold significantly to customers outside the intended target market.

Implementation

The original implementation date of 5 April 2021 was put back to 5 October 2021 because of the effects of the Covid pandemic, and final regulatory guidance – RG 274 – was published in December 2020.

The legislation sought to rebalance the responsibility for consumer outcomes by deliberately increasing product providers' responsibility beyond disclosure, and thus relying less on consumers' financial literacy and financial advice than previously.

Any financial product that requires a Product Disclosure Statement (PDS), prospectus or disclosure to investors under the Corporation Act is in the scope of the DDO, so that includes insurance, asset management products, derivatives, some superannuation products (not MySuper/MyChoice) and some credit products, but not products obtained through personal advice or ordinary company shares.

For every product in scope, providers need to produce a "clear and concise" Target Market Determination (TMD) document. This TMD sets out the type of consumers for whom the product may be appropriate and why, and how long they should consider holding the product. It also needs to describe any triggers that would prompt a review of the TMD and how often a scheduled review should take place, i.e. it must have an expiry date.

Impact on Distributors

Any product with an expired TMD must be taken off the shelf by distributors. As well as that, distributors' obligations include matching clients with appropriate products, which could involve collecting more data on clients than previously, and feeding back to product issuers information such as complaints, large deals, sales outside the target market and any breaches of triggers previously identified for a review of the TMD.

How distributors can monitor the triggers and how they feed information back to the product issuers is more than just a logistical issue, as platforms that have the sales data on products may not have enough information about the end clients to know whether they fall in or out of the target market, while distributors will need to have this data as part of their "reasonable steps" obligation.

Fortunately, a late change just weeks before the implementation of DDO was to remove the need for distributors to provide "nil returns" to issuers on a periodic basis. Again this was similar to the experience in Europe, where it is felt that it is not technically possible to have sales outside the target market in the case of UCITS funds, as they are, by definition, non-complex products that are appropriate for any retail investor.

While the DDO is now in force and the financial services industry gets used to a new regulatory regime, this is only the start of the journey. We now wait to see how the definitions of the target market for products develop, how the monitoring and review of TMDs is handled in practice, and how distributors cope with the responsibilities of ensuring products are only bought by those for whom they are suitable and feed back any exceptions to the product issuers.

Early feedback from the FSC, the industry trade body, is that there are some inevitable teething problems, such as how best to deal with funds in a diversified portfolio. Similar to the experience in Europe, the possible inclusion of a small weighting of "riskier" funds in a portfolio of otherwise appropriate investments could be seen as a technical breach of the TMD, although it may be perfectly justifiable.

Any financial product that requires a Product Disclosure Statement (PDS), prospectus or disclosure to investors under the Corporation Act is in the scope of the DDO

Tracking Progress on the Cross Border Distribution of Funds Regime

The EU Directive 2019/1160 and Regulation 2019/1156, better known as the Cross-Border Distribution of Funds (CBDF) Directive and Regulation, were launched in July 2019, having been initially proposed by the EU Commission a year earlier. Both a Directive and a Regulation were needed because the Commission was making amendments to existing directives (UCITS and AIFMD) and regulations (PRIIPs, venture capital funds and social entrepreneurship fund regulations). The CBDF came into effect on 2 August 2021 and affects all UCITS and Alternative Investment Funds (AIFs), meaning fund groups and asset managers operating in different jurisdictions need to review their operations. But, with a number of outstanding questions still remaining unanswered at policy level, this is proving to be a difficult task for many fund groups.

What the Directive set out to achieve

The Directive set out a number of different measures which were designed to reduce regulatory barriers to the selling and distribution of investment funds across different jurisdictions in Europe. The Directive was designed to standardise different rules between European territories, improve transparency within the marketplace and provide economies of scale for the asset managers selling investment funds and the end investors who buy them.

The need for greater flexibility within the market was set out by the European Parliament, which found that prior to the development of the regulations, approximately 70% of investment funds were only registered for sale in their own domestic markets. Additionally, only 37% of UCITS funds and 3% of AIFs were registered for distribution in more than three EU Member States.

What the Directive introduced

The Directive and Regulation introduced a number of conditions from 2 August 2021 which will affect all UCITS funds and AIFs.

The Directive impacts:

- The pre-marketing of AIFs
- The provision of local facilities for AIFs and UCITS being marketed to retail investors
- A process to de-notify marketing of an AIF or UCITS in a host Member State

The Regulation impacts:

- Requirements around marketing communications
- Verification of marketing communications
- The publication of a central database containing national marketing requirements, fees and charges
- The creation of a list of AIFs, UCITS and their managers to improve transparency

What changed

Several updates were introduced in the months leading up to the live date, causing a degree of uncertainty for fund groups. Points 1 and 2 of Article 1 of the Directive and the impact it has on Article 92 of Directive 2009/65/EC (the UCITS Directive) demanded a lot of attention, with new wording being introduced for Article 92:

Member States shall ensure that a UCITS makes available, in each Member State where it intends to market its units, facilities to perform the following tasks:

- process subscription, repurchase and redemption orders and make other payments to unit-holders relating to the units of the UCITS, in accordance with the conditions set out in the documents required pursuant to Chapter IX;

- provide investors with information on how orders referred to in point (a) can be made and how repurchase and redemption proceeds are paid;

- facilitate the handling of information and access to procedures and arrangements referred to in Article 15 relating to the investors' exercise of their rights arising from their investment in the UCITS in the Member State where the UCITS is marketed;

- make the information and documents required pursuant to Chapter IX available to investors under the conditions laid down in Article 94, for the purposes of inspection and obtaining copies thereof;
- provide investors with information relevant to the tasks that the facilities perform in a durable medium; and

- act as a contact point for communicating with the competent authorities.

Member States shall not require a UCITS fund to have a physical presence in the host Member State or to appoint a third party for the purposes of paragraph X.

According to point 3 of Article 1, the facilities mentioned in point 1 must be provided in the official language or one of the official languages of the Member State where the UCITS is marketed, or in a language approved by the competent authorities of that Member State.

Post-implementation: What questions remain?

Although the CBDF regime is considered to be one of the major changes to impact the marketing of funds in Europe, in reality the Directive has only seen a minority of Member States fully implement the CBDF into their local regulations following the effective date of 2 August 2021. Leading countries observed to have done this include Belgium, Denmark, France, Germany, Hungary, Ireland, Liechtenstein, Luxembourg and Poland.

Currently there are regulators that are still not in a position to implement the Directive, and of those that have met the deadline for implementation, none

Although the CBDF regime is considered to be one of the major changes to impact the marketing of funds in Europe, in reality the Directive has only seen a minority of Member States fully implement the CBDF into their local regulations following the effective date of 2 August 2021 have been able to provide a level of detail that adequately explains all the revised requirements that have been introduced and how they have been introduced to local legislation.

Home and Host regulators are differing in their approach to the one-month notice period for the launch of new share classes, with some waiving it completely. There are also differing approaches as to when a KIID is required and whether any formal approval should be issued by the Home or the Host regulators.

The requirements in respect of the provision of the facility to process the purchase and redemption of shares and to make payments to investors are also differing from jurisdiction to jurisdiction, as is how the information in respect of the facility is provided to investors. Whether this information should be translated into the Host language, whether it should be jurisdiction-specific, and whether it should be part of the prospectus has not been made clear in the Directive and there is no uniformity across regulators in their approach.

To add to the confusion regarding the provision of facilities to investors, third parties which have previously provided paying agent services are withdrawing from the market completely, are interpreting the requirements differently or are only able to offer a subset of the requirements.

Despite the lag in implementation and the guidelines lacking clarity, updates are happening on a daily basis. FE fundinfo's in-house cross-border distribution specialists are taking a very pragmatic approach to the current situation in which there is no clear end date for when the regulations will be implemented in full by all Member States. We are liaising with the regulators and third parties in each of the EU jurisdictions to build a concise picture of the requirements.

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For more information, please visit: **fefundinfo.com**

w: fefundinfo.com
e: enquiries@fefundinfo.com