ReedSmith

Driving progress
through partnership

Reed Smith International RCOM Quarterly

Issue 1 – December 2017

In this issue

TRID — The Beat Goes On: Will the CFPB Finally Plug the 'Black Hole'? – Bob Jaworski

Why Soft Dollars Can Be a Hard Issue – Don Andrews and David Calligan

Germany: MiFID II- Impacts on Asset Managers – Simon Grieser

Dealing with 'Broken-Deal' Expenses: SEC Recent Action Shows Its Continued Focus on Fee and Expense Practices of Fund Managers – Parik Dasgupta

Watch out for PRIIPs – Tim Dolan and Adrian Brown

Introduction

On behalf of my colleagues at Reed Smith, welcome to the inaugural issue of the *International RCOM Quarterly*. The *Quarterly* is devoted to bringing you valuable perspective on risk and compliance issues from around the world. Our RCOM team works with organizations across several industries on a cross-disciplinary basis to identify and resolve important risk and compliance challenges they are facing.

As global regulatory challenges mount – and cooperation between domestic regimes continues to proliferate – this publication is both timely and necessary. Our authors apply their experience in advising clients on complex risk management and compliance issues to their contributions to the *Quarterly*, with the intention of educating and informing our readers. With this in mind, we encourage you, our readers, to share your questions and opinions, and to contribute to the overall discussion of the issues discussed herein with our editorial team, as you are often the best source for future content ideas.

We look forward to providing you valuable insights and taking part in a conversation in the months and years to come.

Don Andrews
Partner and Global Practice Leader of Risk Management and Compliance
Reed Smith LLP

This issue of the International RCOM Quarterly was edited by Bonnie Mangold, an associate in Reed Smith's Financial Industry Group, practicing in the areas of financial services litigation and regulation.

TRID – The Beat Goes On: Will the CFPB Finally Plug the "Black Hole"?

When, after years of effort, the Bureau of Consumer Financial Protection ("Bureau") finally adopted its Truth in Lending/RESPA Integrated Disclosures Rule ("TRID" or the "Rule") near the end of 2013, it inadvertently created a "black hole" or "gap" with respect to creditors' ability to "reset tolerances." These tolerances define the limits on how much certain settlement charges a residential mortgage loan borrower is required to pay at or before closing are permitted to increase from the amounts disclosed on the borrower's initial Loan Estimate. After industry members brought the existence of this gap to the Bureau's attention, the Bureau sought to close it by means of a proposed rule published in the *Federal Register* August 15, 2016, which also sought to resolve a number of other issues with the Rule. When it came time to adopt a final rule, however, the Bureau decided not to adopt its proposed black hole fix and, instead, to propose a slightly different fix.

This article presents a detailed explanation of the black hole and discusses various issues surrounding it, including (1) why it is important to the industry that it be closed, (2) the Bureau's initial proposal to fix it and the reasons why the Bureau elected not to adopt it, (3) the Bureau's current proposal to fix it and how it differs from the earlier proposal, (4) whether the new proposal will actually fix the problem, and (5) how likely it is that the new proposal will be adopted in its current form.

Robert M. Jaworski
Partner, Princeton

What is the "Black Hole"?

Requirement to Provide Loan Estimate. To help consumers shop for a home mortgage loan, TRID requires creditors, within three business days after receiving a loan application from a consumer, to give the consumer a written Loan Estimate ("LE") on a prescribed form. The LE sets forth the basic terms of the loan for which the consumer is applying, and "good faith" estimates of the various fees and charges the consumer will have to pay in connection with the loan. The disclosed loan terms and fee estimates on the LE must remain fixed for at least 10 business days. During this 10-day period ("10-Day Shopping Period"), the consumer may use the LE to shop with other mortgage lenders for better terms and fees. If, by the end of this 10-Day Shopping Period, the consumer has not informed the creditor that he/she wishes to proceed with the application, the LE expires, and the creditor is free to issue a different one.

Good Faith/Tolerances. With two exceptions, TRID provides that fee estimates on the LE are subject to a "zero tolerance," meaning that to be considered in "good faith," they must not exceed the amounts the consumers actually have to pay for those particular services ("Zero Tolerance Fees"). The two exceptions are for estimates on the LE for (1) certain fees paid to third-party service providers, which are considered to be in "good faith" so long as the sum of the actual amounts the consumer pays for these services does not exceed by more than 10% the sum of the estimates ("10% Tolerance Fees"); and (2) certain other fees, which are considered to be in "good faith" so long as they were based on the best

information reasonably available to the creditor at the time ("Changeable Fees"). Creditors must make refunds or provide credits to consumers whenever these tolerances are exceeded.

Ability to Reset Tolerances Using Revised LEs. Because LEs must be given to the consumer very early in the process and based on very limited information, and recognizing that the mortgage loan process is a fluid one, TRID permits creditors, under limited circumstances, to issue revised LEs, which can then be used, in place of any previous LE, to determine whether the actual charges the consumers pay exceed the applicable tolerance (to "reset tolerances"). The circumstances permitting tolerance resets include "changed circumstances" (as defined in TRID) that affect settlement charges or eligibility; consumer-requested changes; interest rate dependent changes; and expiration of the 10-Day Shopping Period with no indication from the consumer of an intent to proceed with the application (collectively, "Changed Circumstances").

To take advantage of this ability to reset tolerances, creditors must issue revised LEs within three business days after receiving information sufficient to establish that a Changed Circumstance exists. Also, creditors must ensure that the consumer receives any revised disclosures no later than four business days before consummation. Unrelated but very important, TRID also prohibits creditors from issuing a revised LE once they have provided a Closing Disclosure ("CD") to the consumer, and requires them to provide a CD to the consumer by no later than three business days before consummation.

Ability to Reset Tolerances Using CDs. Recognizing that some Changed Circumstances can occur very near to consummation, TRID also permits creditors in certain circumstances to reset tolerances using the CD. It states: "If … there are ***less than four business days*** [emphasis added] between the time [a] revised [LE] … is required to be provided [i.e., within three business days after learning of the Changed Circumstance] … and consummation, creditors comply with the [good faith] requirements … if the revised disclosures are reflected in the [CD]" ("Four-Day Limit"). Since creditors are required to provide revised LEs within three business days after learning of a Changed Circumstance, the Four-Day Limit translates into a requirement that creditors may use the CD to reset tolerances only in situations where they first learn of the Changed Circumstance no later than the sixth business day before consummation.

The Black Hole. The "black hole" refers to several "gaps" within which creditors that learn of a Changed Circumstance after having provided the CD to the consumer are nevertheless not explicitly permitted under TRID to reset tolerances. One such "gap" is where the creditor learns of a Changed Circumstance ***more than six business days*** before the scheduled closing. Another "gap" is where the creditor learns of a Changed Circumstance ***six business days or fewer*** before the scheduled closing, but for some reason the closing must be postponed, causing consummation to occur more than six business days after the creditor learned of the Changed Circumstance. In addition, by not specifically permitting creditors that learn of a Changed Circumstance after having provided the CD to reset tolerances using a ***corrected CD***, TRID casts doubt on creditors' ability to do that, even in situations where the creditor learns of the Changed Circumstance six business days or fewer before consummation.

The 2016 Proposal

The Bureau proposed in 2016 to close the black hole by adding Comment 19(e)(4)(ii)-2 to the Official Staff Commentary to Regulation Z (Commentary) (81 Fed. Reg. 54317 (August 15, 2016)). This Comment states: "If there are fewer than four business days between the time the revised [LE] is required to be provided … and consummation ***or the [CD] … has already been provided to the consumer*** [emphasis added], creditors comply with the [good faith] requirements … if the revised disclosures are reflected in [a] corrected [CD]…, subject to the … requirement[s] to provide revised disclosures within three business days after learning of a Changed Circumstance]." This Comment appears to allow creditors to reset tolerances not only by means of a CD where they learn of a Changed Circumstance six business days or fewer before consummation, but also by means of a corrected CD where they already provided a CD to the consumer before learning of the Changed Circumstance.

Many industry commenters interpreted this proposed fix to mean that, in instances where CDs have already been delivered to the consumer when the creditor learns of a Changed Circumstance, corrected CDs could be used to reset tolerances regardless of when consummation is expected to occur, so long as the creditor provides the corrected CD to the consumer within three business days after learning of the Changed Circumstance - and even if that is at the closing table. In other words, these commenters read the proposal as eliminating the Four-Day Limit in situations where the CD has already been issued when the creditor learns of a Changed Circumstance. Other industry commenters expressed concern that adoption of the Bureau's proposed fix would still leave uncertainty concerning the situation where creditors that have not yet provided a CD to the consumer, learn of a Changed Circumstance six business days or fewer before consummation. The first part of the proposed Comment would appear still to apply in that instance, and to prohibit the creditor from using the CD to reset tolerances.

Consumer advocacy groups, on the other hand, warned that the Bureau's proposed fix could encourage creditors to deliver CDs to the consumer very early in the loan

TRID – The Beat Goes On: Will the CFPB Finally Plug the "Black Hole"?

process, which would be inconsistent with the Bureau's intent that the CD be a statement of actual costs. They also expressed concerns that allowing creditors to issue corrected CDs to consumers under these circumstances could result in information overload.

In analyzing these comments, the Bureau recognized that the industry commenters' interpretation of the Bureau's proposed fix as eliminating the Four-Day Limit was a plausible reading of the language in Comment 19(e)(4)(ii)-2, but noted that the preamble to the proposal "does not describe that the Bureau intended such a change." The Bureau also acknowledged that if the proposal were to be adopted as is, it would not end the uncertainty surrounding this issue and, further, could produce unforeseen and, perhaps, adverse consequences for consumers. Accordingly, the Bureau determined not to adopt the proposed Comment and to instead propose a new fix.

The 2017 Proposal

The 2017 proposal (82 Fed. Reg. 37794 (August 11, 2017)) appears to satisfy most, if not all, of the industry's concerns. It removes any doubt that both corrected CDs and initial CDs may be used to reset tolerances regardless of when consummation occurs, so long as the creditor provides the CD or corrected CD to the consumer within three business days after learning of the Changed Circumstance. It also includes, as proposed new Comments 19(e)(4)(ii)-1(iii) and (iv), the following two helpful examples illustrating exactly how the proposed fix works in real life scenarios:

> *Example 1*: Consummation is scheduled for Thursday. The creditor hand delivers the [CD] on Monday, and, on Tuesday, the consumer requests a change to the loan that would [justify issuance of] a revised disclosure … but would not require a new [three business day] waiting period pursuant to § 1026.19(f)(2)(ii). The creditor complies with the [good faith] requirements … by hand delivering [a corrected CD] reflecting the consumer-requested changes on Thursday.
>
> *Example 2*: Consummation is originally scheduled for Wednesday. The creditor hand delivers the [CD] on the Friday before the scheduled consummation date and the APR becomes inaccurate on the Monday before the scheduled consummation date, such that the creditor is required to delay consummation and provide [a] corrected [CD], including any other changed terms, so that the consumer receives [it] at least three business days before consummation…. Consummation is rescheduled for Friday. The creditor complies with the [good faith] requirements … by hand delivering the [corrected CD] … reflecting the revised APR and any other changed terms to the consumer on Tuesday….

The Bureau gives several reasons for putting forth this new proposal to close the black hole. It indicates that if creditors cannot recoup increases in costs resulting from Changed Circumstances that occur late in the loan process, they may likely charge higher fees to all of their customers, refuse to agree to consumer-requested changes, and/or refuse to close and force the consumer to start the loan process all over again. It also suggests that eliminating the Four-Day Limit for issuance of corrected CDs, but not for the initial CD, would provide an incentive to creditors to issue CDs very early in the process, which in some circumstances "might be inconsistent with the description of the [CD] as a 'statement of the final loan terms and closing costs,' and the requirement … that the disclosures on the [CD] are to be a statement of 'the actual terms of the transaction.'" Finally, the Bureau recognizes that the "current timing rules regarding resetting tolerances with [CDs] have led to uncertainty in the market and created implementation challenges that could have unintended consequences for both consumers and creditors.

Prospects for Adoption of 2017 Proposal

Whether the Bureau will adopt the proposal in its current form is unclear. While the Bureau has indicated that there are several good reasons to do so, it is obviously concerned, as set forth above, about some of the possible ramifications and unintended consequences that could result. Because of this concern, it solicits comments from interested parties regarding the possible effects of the changes it has proposed. (The comment period expires October 10, 2017.)

Among the items of information sought by the Bureau in this regard are the following:

- Information concerning the extent to which the current rule has caused situations where creditors cannot provide either a revised LE or CD to reset tolerances, even if a Changed Circumstance would otherwise permit them to do so.

- The frequency and the cause of such occurrences, specifically including whether the Changed Circumstance occurred after the CD had been provided to the consumer, and whether there was a delay to the expected consummation date after the creditor provided the CD.
- The average costs and the nature of such costs (e.g., rate lock extension fees, additional appraisal or inspections fees, or other fees) associated with such occurrences.
- Any additional information that would assist the Bureau in evaluating potential adverse consequences of the proposal, such as encouraging some creditors to provide CDs very early in the lending process, possibly so early in the process that the terms and costs are nearly certain to be revised.
- The extent to which creditors are currently providing CDs to consumers so that they are received substantially before the required three business days prior to consummation with terms and costs that are nearly certain to be revised, and, to the extent this is occurring, the number of business days before consummation consumers are receiving the CDs.
- Whether creditors, in those instances, are issuing revised CDs.
- The extent to which creditors might change their current practices regarding providing the CD if the proposal is adopted.
- The potential harms to consumers where creditors provide CDs to consumers so that they are received more than the required three business days prior to consummation, with terms and costs that are nearly certain to be revised, and whether it should consider adopting measures to prevent such harms in a future rulemaking.
- Whether the circumstances for resetting tolerances [using a revised LE] provide sufficient protection against potential consumer harm, or whether additional limitations are appropriate for resetting tolerances after the issuance of a CD.
- Whether it would be appropriate to allow creditors to reset tolerances with a corrected CD in circumstances that are more limited than those described in [the proposed rule] (for example, only when the increased costs result from a consumer request or unforeseeable event, such as a natural disaster).
- Whether the rule should be more restrictive for resetting tolerances with a corrected CD for certain third-party costs (such as appraisal fees) and creditor fees (such as interest rate lock extension fees), and the types of costs and fees that might be subject to any more restrictive rules.
- Whether removing the [Four Day Limit] might result in confusion or information overload to the consumer as a result of receiving more corrected CDs.
- Any additional consumer protections that might be appropriate to promote the purposes of the disclosures, or prevent circumvention or evasion, and additional potential consumer harms the Bureau has not identified.

Prognosis

Most of the Bureau's concerns about unintended and possibly adverse consequences for consumers resulting from adoption of the 2017 Proposal — consumer confusion, information overload and receipt of early CDs that will likely have to be revised — appear to be highly speculative. As a result, unless consumer advocacy groups are able to offer actual examples of adverse consumer consequences along the lines suggested in the Bureau's request for comments, and perhaps some evidence that these consequences are not merely isolated events, it does not seem likely that the Bureau will back off from finalizing this proposal as published. On the contrary, if the Bureau is provided with some real-world evidence of adverse consumer consequences, it could adopt the proposal with limitations, on either the types of third-party costs and creditor fees that will qualify for a tolerance reset under the new rule, or the number of days before the scheduled closing date within which a CD may be delivered, or both. In any event, one thing is certain – the TRID beat will go on.

Robert Jaworski is a partner in the Financial Industry Group of Reed Smith LLP in Princeton, New Jersey. He is a former deputy commissioner of the New Jersey Department of Banking; a former chair of the New Jersey Bar Association's Banking Law Section and co-chair of the RESPA and Housing Finance Subcommittee of the American Bar Association's Consumer Financial Services Committee; a former editor of Pratt's Mortgage Compliance *letter, a national publication on mortgage compliance issues; and a Fellow of the American College of Consumer Financial Services Lawyers. Robert can be reached at rjaworski@reedsmith.com.*

This article was reproduced with permission from BNA's Banking Report, 109 BBR 1422, 10/23/17. Copyright _ 2017 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Why Soft Dollars **Can Be a Hard Issue**

Don J. Andrews
Partner, New York

David A. Calligan
Partner, London

Cultural And Global Entanglements

Global De-Coupling

In 2008, we felt the consequences of a globally interconnected economy, and the world still today is working to shake off the after-effects. It can be argued that the aftershock of the near global meltdown has manifested itself in populist elections and movements in the United States and the UK, as well as in the desire for regulatory reform in the United States that de-couples the United States from the effect of global over-reach.

Given the above, a number of the impending Markets in Financial Instruments Directive II ("MiFID II") regulations could not have come at a worse time. While the full effect of the new MiFID II regulations is still unknown, there is no single regulation that is causing as much consternation on both sides of the Atlantic as the European Union's changes affecting how research is paid for by investment firms. In the United States, government regulations – some in the form of Executive Orders – have required that regulatory agencies undertake substantial efforts to understand the potentially adverse impact of their proposed regulations in terms of cost and burden, as a *pre-condition* to their enactment. If this is the new standard for U.S. government regulators, potentially burdensome regulations from *non-U.S. regulators* enacted by legislators sitting in Brussels will not be welcomed with open arms.

The Effect of MiFID II Enactments

As of January 2018, EU managers will no longer be able to use client dealing commissions, referred to in the United States as "soft dollars," to pay for research from broker-dealers.[1] The view of regulators in Europe is that this practice has been abused and now must be reined in. It has been argued for some time by critics of "soft dollar" arrangements that customers are paying higher execution costs because the cost of research is "bundled" and included in an opaque manner in the all-inclusive dealing commission. Similarly, it has been argued that *certain customers* have been tagged for research costs utilized by *other customers,* and that this is an unfair practice.

The view in the United States is sharply different. First, there are thousands of small investment advisers who greatly rely on research provided by broker-dealers with large and highly resourced research departments. These small advisers cannot afford the expense of maintaining significant research capability, and even if they could, this cost would need to be passed on to their clients.

U.S. regulators are largely sympathetic to their U.S. registrants, and have maintained the view that small investment advisers do provide a significant contribution to U.S. investors and the economy. As such, U.S. regulators have been reluctant to take sweeping action that would adversely affect these small advisers on the basis of what are perceived in the United States as largely unsubstantiated generalizations. Moreover, industry groups have argued that U.S. investors would actually be harmed by actions endangering these smaller advisers. The United States, with its emphasis on states' rights, local control, and antipathy to monopoly, is not fertile ground for legislation that could be harmful to smaller advisers, small financial institutions or community banks.

Challenges In Application

Operational Challenges

When the SEC proposes a new requirement, a proposed rule and comment period lasting a minimum of 30 to 60 days follows. During the comment period, the financial industry is able to provide observations on potential harmful effects or perceived inefficiencies of the rule, and in certain cases the SEC takes these comments into consideration and revises the rule prior to its final version. As MiFID II is a foreign regulation *affecting* U.S. businesses, no such "comment period" was possible. Moreover, it does not appear that an exhaustive study was conducted as to how the regulation could affect non-EU sub-advisers.

Consequently, the full effect of how U.S. firms will be affected by the rule is unknown. While it is clear that MiFID II will apply to U.S.-owned investment firms based

[1] Commission Delegated Directive (EU) 2017/593, Articles 13, 14 (April 7, 2016).

in the EU, the "pass-through" effects are unclear. U.S. firms are reviewing sub-advisory and affiliate relationships for potential application. The safe approach is that MiFID II should be construed as having application wherever an EU-based manager delegates investment responsibility or trading discretion to U.S. managers. The UK's Financial Conduct Authority (FCA) has said that, under delegation arrangements, the FCA firm must "secure for its clients substantively equivalent outcomes as they would expect to receive based on the relevant investor protection provisions in MiFID II."

Although section 28(e) provides a safe harbor for a U.S. manager from a claim by investors that it has paid excessive commissions under certain circumstances, aspects of 28(e) run counter to the new MiFID II requirements. For instance, 28(e) allows investment advisers, with appropriate disclosure, to pool research capabilities for all clients, even though some research may benefit some clients more than others. The view is that in the end, the effect will be negligible. However, this arrangement is disallowed by the MiFID II requirements, which requires firms to allocate the costs of research fairly to clients based on who benefits from particular research. This is important in administering research payment accounts ("RPAs"), which are the only way that firms can use client payments to buy research.

This means that order flow for MiFID II accounts in some cases may need to be segregated from accounts that benefit from the safe harbor under 28(e). This also means that firms may require new operational trading mechanisms, along with identifying potential issues through painstaking risk assessments, compliance controls, supervision and monitoring. Orders that are allocated under MiFID II may need to be filled on a different basis, or even partially filled as a result of the need to segregate accounts based upon evaluating the usefulness of research for each type of client. The difficulties in administering the RPAs are leading many managers to the conclusion that they will pay for research from their own resources, rather than ask clients to fund it directly.

Further Unforeseen Effects

The fact that broker-dealers now need to issue a separate invoice to UK investment managers for the cost of research in "hard dollars" has triggered additional issues for U.S. broker-dealers. This issue was just addressed by the SEC in a recent no-action letter, albeit the SEC only provided temporary relief.

The Advisers Act regulates the activities of investment advisers and requires that such investment advisers register and become subject to an entirely different regulatory regime than broker-dealers. In 2005, the SEC clarified the fact that broker-dealers who provide advisory services that are purely "incidental" to their business and receive "no special compensation" for such services, are not required to register as investment advisers. This means that broker-dealers who provide research as a complementary service to trade execution and do not separately charge for the service will not be deemed as providing investment advice. In other words, if broker-dealers are selling research as a separately identifiable core part of their service, they are no longer just broker-dealers, they are also investment advisers.

The recent SEC no-action letter issued October 26 "provides a path for market participants to comply with the research requirements of MiFID II in a manner that is consistent with the U.S. federal securities laws." However, the relief is only temporary, as the SEC is taking a "wait and see" approach with the new MiFID II implementation. Broker-dealers, on a temporary basis, may receive research payments from money managers in hard dollars or from advisory clients' research payment accounts. This relief will remain in place for 30 months, as the SEC evaluates the process. The most telling phrase from the Commission is as follows:

"The temporary no-action relief facilitates compliance with the new MiFID II research provisions while respecting the existing U.S. regulatory structure. It also is intended to provide the staff with sufficient time to better understand the evolution of business practices after implementation of the MiFID II research provisions."

In other words, granting temporary, as opposed to permanent, relief is a signal to European regulators that while American regulators are willing to make efforts to protect their registrants from involuntary regulatory violations, they are not willing to let European regulators dictate to them what permissions to grant to certain registrants on a permanent basis.

Conclusion

Even though the effect of "globalism" is being met with a political backlash, we cannot escape the fact that the world is a global marketplace. As such, the connections between the world economy and regulatory regimes should be taken into consideration by the financial community, and especially so by the global regulators. As we work to unwind and face the challenges and effects of MiFID II enactments, it is perhaps a lesson for further regulatory initiatives to study the full effect of national or continental regulatory changes on our global partners as a pre-condition to enacting such legislation.

Don Andrews is a New York-based partner in Reed Smith's Financial Industry Group and global practice leader for Risk & Compliance. Don can be reached at dandrews@reedsmith.com.

David Calligan is a London-based partner in Reed Smith's Financial Industry Group. David can be reached at dcalligan@reedsmith.com.

Germany: MiFID II - Impacts on Asset Managers

When the Markets in Financial Instruments Directive II ("MiFID II" or the "Directive") entered into force July 2, 2014, EU legislators were obliged to incorporate the Directive into their legislations by July 3, 2016. After seven years in the making, this extensive piece of legislation alters and expands MiFID I obligations and is transforming Europe's financial industry. MiFID II and the Markets in Financial Instruments Regulation ("MiFIR") govern comprehensive regulations to make European markets safer, more transparent and more efficient. While on the one hand these goals are *inter alia* improving the investors' protection, on the other hand, they are also challenging investment service providers to comply with the underlying regulations.

In particular, issues related to product governance, inducements, reporting, and costs and charges are proving to be specific compliance challenges for asset managers. These key areas are *inter alia* affected by the German incorporation (Zweites Finanzmarktnovellierungsgesetz "2.FiMaNoG"), which is comprehensively regulating German law, such as the Wertpapierhandelsgesetz ("WpHG"), and the Wertpapierdienstleistungs-Verhaltens-und Organisationsverordnung ("WpDVerOV").

Given the changes of legal requirements, asset managers will be required to modify their processes, controls and policies to comply with MiFID II regulations by January 3, 2018. The following text focuses on the impacts of MiFID II on asset managers in relation to the above-mentioned key areas.

Dr. Simon G. Grieser
Partner, Frankfurt

Product Governance

The product governance regime under MiFID II is one of the key challenges for asset managers. This regime leads to the obligation to ensure the client's best interests and requires that asset managers carry out detailed assessments of their products. The new regime includes a greater knowledge of the customer itself and the product, which requires an analysis of an appropriate and suitable target market for their clients. The suitability analysis requires prior information about the client's knowledge, the financial situation and the investment objectives. In addition, the appropriateness analysis based on the above-mentioned client's information determines the type of financial services, transaction or regulated financial instruments. The asset manager has to determine not only the type, but also the nature, volume and frequency of the financial service, transaction or regulated financial instrument. After defining a suitable and appropriate product, product governance includes a duty of monitoring the target product and hence its risks and income.

Inducements

Once implemented, asset managers are generally prohibited from receiving and retaining third-party inducements, per section 64, paragraph 7, sentence 1 of the WpHG. Asset managers are allowed to receive inducements under the condition that the payments will be passed on in full to clients. An exception of this prohibition is the acceptance of minor non-monetary benefits. However, retaining minor non-monetary benefits, pursuant to section 64, paragraph 7, sentence 2 of the WpHG, are subject to several conditions as well. Those conditions are, first, the suitability for enhancing the financial services to the client and, second, the exclusion of an impairment of the asset manager's duty to act in the client's best interests. In addition, other inducements, like portfolio commissions, have to constitute an on-going advantage, per section 6, paragraph 2, sentence 1, number 3 and paragraph 2, sentence 3 of the WpDVerOV. Additionally, asset managers are obligated to inform clients, if possible, *ex-ante* about non-monetary benefits. If a concrete assessment is not possible, suitable information has to be given *ex-post* to the client. Regarding continuous benefits, clients shall be annually informed about accrued benefits.

Furthermore, pursuant to Article 13, MiFID II third-party research shall in the future also be classified as monetary inducements. Because of this fact, asset managers will no longer be able to use research services free of charge from banks or financial service providers unless two exceptions are applied: research is not a monetary benefit when an asset manager is either directly paying the fee out of its own resources, or by paying the benefit from a separate research payment account. To set up the former exception, asset managers will be required to implement new internal systems, procedures and controls to comply with the transparency requirements. Such an account has to be funded by a specific research charge to a client controlled by investment firms; they have to set up a research budget and agree with clients on the frequency of this charge; and, finally, they have to evaluate used research on a regular basis in relation to their enhanced contributions for the clients' investments.

Needless to say, new regulations under MiFID II that require asset managers to constantly review the value of research, to fulfill the mandatory disclosure requirements of the German Financial Supervisory Authority – Bundesanstalt für Finanzdienstleistungsaufsicht (otherwise known as BaFin), and to provide clients with information pertaining to research transactions upon request, are presenting these managers with new policy challenges.

Cost and Charges

To improve investor protections, a comprehensive disclosure of costs is now required pursuant to MiFID II. This disclosure obligation is *inter alia* mentioned in section 63, paragraph 6 of the WpHG, and includes an aggregation of all costs and charges associated to the investment service and the financial instrument. By means of the provided information, the client shall be able to understand the overall costs. This includes, in particular, *ex-ante* disclosure, which contains an indication of expected costs, and *ex-post* disclosure based on *ex-ante* information and incurred costs.

Transaction reporting

Furthermore, asset managers will be obliged to report their transactions to monitor market abuse in capital markets. To comply with this regime, addressees have to put a powerful IT solution in place. This presents a challenge to asset managers, as they are now obligated to report all trade details of each transaction within the following day.

For asset managers, the impact of MiFID II extends into other areas beyond those discussed above. Recording conversations with clients, assessing trade execution and operations, and the limitation of execution-only are also relevant issues. Therefore, MiFID II has a significant impact on asset managers, and represents a challenge of compliance on several levels that are mainly caused by the extensive observance and information obligations.

Dr. Simon G. Grieser is a founding partner of Reed Smith's Frankfurt office and a member of the firm's Financial Industry Group. His practice focuses on the advice of national and international financial institutions in connection with banking & finance and banking regulatory issues, as well as on securitization. Simon can be reached at sgrieser@reedsmith.com.

Dealing with 'Broken-Deal' Expenses: SEC Recent Action Shows Its Continued Focus on Fee and Expense Practices of Fund Managers

On September 21, 2017, the SEC announced that it had settled an enforcement proceeding against a private equity fund manager alleging that the manager's private equity funds were inappropriately allocated, and charged broken-deal expenses attributable to affiliated co-investors.

Parikshit Dasgupta
Partner, New York

According to the SEC's order, from 2004 to 2015, the three main private equity funds of the fund manager (the "PE Funds") invested in 85 companies, and several co-investors participated in these investments. During this time, the PE Funds incurred expenses attributable to investments that did not proceed to completion. Such expenses are typically defined in the fund documents as "Broken-Deal Expenses" or "Abort Costs." While the co-investors participated in the fund's successful transactions and benefited from sourcing of investments (and were allocated proportionate expenses), the fund manager did not allocate any of the broken-deal expenses to the co-investors.

For each portfolio investment by the Private Equity Funds, co-investment occurred via a separate co-investment vehicle. The fund manager did not have a standing committed capital co-investment vehicle. Rather, the fund manager used a separate vehicle to co-invest in each consummated private equity transaction. While certain of the co-investors, who were typically officers, directors, executives, and employees of the fund manager, repeatedly co-invested through these co-investment vehicles, some of the co-investors did not, and the make-up of the co-investors varied to some extent from transaction to transaction. The contracts governing these co-investment vehicles provided that these vehicles paid their pro rata share of expenses related to the investment held by such vehicle, but they did not provide for allocation of broken-deal expenses of the PE Funds.

The SEC alleged that the PE Funds' governing documents did not contain sufficiently detailed disclosure to permit the PE Funds to bear the entire amount of broken-deal expenses, without an appropriate allocation to the co-investors.

Typically, the governing documents of a private equity fund include provisions to the effect that broken-deal expenses (e.g., research costs, travel costs and professional fees, and other expenses incurred in deal-sourcing activities related to specific investments that never materialize) are borne by the fund as expenses incurred by the manager in sourcing deals for the benefit of the fund and its investors. Fund managers have also been reimbursed for broken-deal expenses by deducting such expenses from the "other fees" that the adviser may receive in connection with investments (e.g., monitoring,

transaction and break-up fees) that would otherwise be applied to offset the management fee charged to the fund. In light of the SEC actions summarized above, fund managers must ensure that the disclosures in the fund documents are sufficiently detailed and explicitly address the issue of sharing of broken-deal expenses with any co-investment vehicles.

This SEC action confirms the SEC's continued focus on transparency of fees and allocation of expenses. Therefore, fund managers would be wise to reevaluate their policies and disclosures relating to fees and expense allocation.

Parikshit Dasgupta is a partner in Reed Smith's Corporate & Transactional Advisory Group. His practice focuses on the establishment, management and regulation of private equity funds, hedge funds and other alternative investment funds. Parik regularly represents both U.S. and non-U.S. sponsors of buyout, growth capital, secondary, distressed debt, energy, infrastructure, technology, venture, credit opportunities and geographically oriented (especially India and Latin America) funds.

Watch out for PRIIPs

Tim Dolan
Partner, London

Adrian J. Brown
Partner, London

James Nicholson
Trainee Solicitor, London

In Europe, the Packaged Retail and Insurance-based Investment Products ("PRIIPs") Regulation will enter into force January 1, 2018, and it will have an impact on many types of firms around the world that offer securities to retail investors in Europe.

The main objectives of the PRIIPs Regulation are to provide European retail investors with clear information about the risks of investment products failing, and also to improve the quality and comparability of information provided. PRIIPs should enable investors to make more informed choices between different investment options across product classes. As part of this, firms that "manufacture" PRIIPs must create a key information document ("KID"), which must be provided by distributors to retail investors in good time before they buy.

What is a PRIIP?

PRIIPs can be either:

- An investment where the amount repayable to the investor is subject to fluctuation because of an exposure to reference values, or to the performance of one or more assets that are not directly purchased by the investor. Examples include investment funds, special purpose vehicles, futures, options, contracts for differences, structured products and structured deposits. There is, however, a transitional exemption for European UCITS funds, which will not be brought into the regime until December 31, 2019. Or
- An insurance-based investment product that offers a maturity or surrender value, and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations. This will include life insurance policies with an investment element.

The key point is that PRIIPs are products that intercede between the retail investor and the markets through a process of packaging or wrapping together assets or reference values so as to create different exposures, provide different features, or achieve different cost structures, as compared with a direct holding.

What is a retail investor?

All individuals will be retail investors unless it is possible to "opt them up" to professional investor status. In order to do this, both of the following tests (which derive from Europe's MiFID legislation and do not apply perfectly to this context) need to be satisfied:

- A "qualitative test," where a distributor may treat a person as an elective professional if the distributor assesses the expertise, experience and knowledge of the person, which gives reasonable assurances, and the distributor considers that the investor is capable of making his or her own investment decisions and understands the risks involved.
- A more onerous "quantitative test," where at least two of the following criteria must be satisfied:
    a. The investor has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters
    b. The size of the investor's financial instrument portfolio exceeds EUR 500,000
    c. The investor works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged

Therefore, if the investor satisfies both tests above, it will not be treated as a retail investor for PRIIPs purposes, and will not be subject to the PRIIPs Regulation.

It is also possible in certain circumstances that a corporate or partnership can be considered to be a retail investor, and so care must be taken.

What does a KID need to contain?

The KID must be accurate, fair, clear and not misleading, provide key information, and be consistent with any binding contractual documents, with the relevant parts of the offer documents and with the PRIIP's terms and conditions. It must be a stand-alone document and clearly separate from marketing materials, and not contain cross-references to marketing material.

Additionally, the KID must be written in a concise manner and should be no longer than three sides of A4 paper. It should be presented in a way that is easy to read and must focus on the key information that retail investors need. It shall be written in the official or any other accepted language of the member state where the PRIIP is to be offered or sold.

The following is a prescribed structure that the KID must take:

- The title "Key Information Document" must appear prominently at the top of the first page of the KID
- The KID must then contain a prescribed explanatory statement directly under the title of the KID
- Information on the identity of the manufacturer and its competent authority
- A prescribed comprehension alert
- Specification of the PRIIPs type, its objective and the intended market
- Details of the risks associated with the PRIIP, and a summary risk indicator ("SRI")
- Performance scenarios
- The consequences of a potential default of the manufacturer
- The costs of the PRIIP
- Details as to how long they should hold the PRIIP, and whether they can take out their money early
- How complaints can be made
- Other relevant information

The SRI is a figure that provides information on the risk profile of the PRIIP that is obtained by combining a market risk measure ("MRM") and a credit risk measure ("CRM") with respect to the PRIIP.

The MRM is a measure of the PRIIP's market risk on a scale of one (being the lowest risk) to seven (being the highest risk). This figure is calculated on the basis of the market price of the PRIIP, and its annual volatility in relation to the Value-at-Risk.

The CRM measures the PRIIP's credit risk on a scale of one to six. CRM takes into account the credit risk associated with the manufacturer or the party bound to make payments to the investor. Depending on whether there is an entity that directly engages to pay the return to the investor, and whether the PRIIP invests or is exposed to underlying investments or techniques that entail credit risk, the credit risk assessment will take into account the underlying investments or exposures on either a "look-through" or "cascade" basis.

If the recommended holding period of the KID is three years or more, the KID must contain performance values based over three moments in time: at one year, at half the recommended holding period, and at the recommended holding period. If between one and three years, performance values need to be shown at two moments in time: at one year and at the end of the recommended holding period. If the recommended holding period is shorter than one year, only the values at the end of the recommended holding period need to be shown. These must be calculated net of costs and presented both in monetary and percentage terms. At each of these intervals, the performance scenarios will show a range of possible returns in a stressed, unfavorable, moderate and favorable scenario of the underlying investment. If the PRIIP is an insurance-based investment product, an additional scenario, based on the moderate scenario, shall be included, where the performance is relevant in respect of the return on the investment.

In terms of costs, all direct and indirect costs borne by the retail investor, including one-off, recurring and incidental costs, must be disclosed in the KID.

Under the section titled "How long should I hold it and can I take money out early?" the KID should state whether there is a cooling off or cancellation period for the PRIIP, an indication of the recommended and, where applicable, required minimum holding period, and the ability to make, and the conditions of, any disinvestments before maturity (including applicable fees and penalties).

Under the complaints section, detail is needed about how and to whom a retail investor can make a complaint against the manufacturer, or a person advising on or selling the product.

The final section, "Other relevant information," should have a brief indication of any additional information documents to be provided to the retail investor at the pre-contractual and/or post-contractual stage. This excludes marketing material.

Next Steps

A manufacturer (which will be the firm that creates the PRIIP) must create the KID and make it available on its website. Manufacturers should also ensure that they have an enforceable Distribution Agreement with distributors, making it clear that distributors will need to distribute the KID in accordance with PRIIPs.

A distributor must communicate the KID and make it available to European retail investors in good time before they invest.

All firms involved in the creation and distribution of PRIIPs to retail investors in Europe should be assessing whether they are subject to the new PRIIPs regime.

The authors would like to recognize James Nicholson, trainee solicitor at Reed Smith, for his contributions to this article.

Tim Dolan is a London-based partner in Reed Smith's Financial Industry Group. He is an experienced financial services lawyer who advises on UK and European regulation, and helps clients to deal with the UK's Financial Conduct Authority, the Prudential Regulation Authority, and European regulators. Along with advising on the FCA's and PRA's rules and principles, a substantial amount of Tim's practice involves advising on European directives and regulations, including MiFID II, Payment Services Directive II, the Market Abuse Regulation, REMIT, the Capital Requirements Directive, and the second Electronic Money Directive. Tim has previously worked for several financial services regulators.

Adrian Brown is a London-based partner in Reed Smith's Financial Industry Group. He focuses on financial regulation in funds, structured real estate and AIFMD. When AIFMD was being introduced, he sat on the Investment Property Forum's legislation and working group, and led their response to the FCA and ESMA consultations. Adrian also sat on the EPRA (European Public Real Estate Association) regulation committee, and was closely involved with INREV (European Association for Investors in Non Listed Real Estate Vehicles) in respect of AIFMD.

Reed Smith LLP is associated with Reed Smith LLP of Delaware, USA and the offices listed below are offices of either Reed Smith LLP or Reed Smith LLP of Delaware, USA, with exception of Hong Kong, which trades as Reed Smith Richards Butler.

All rights reserved.

Phone: +44 (0)20 3116 3000
Fax: +44 (0)20 3116 3999
DX 1066 City/DX18 London

ABU DHABI
ATHENS
BEIJING
CENTURY CITY
CHICAGO
DUBAI
FRANKFURT
HONG KONG
HOUSTON
KAZAKHSTAN
LONDON
LOS ANGELES
MIAMI
MUNICH
NEW YORK
NORTHERN VIRGINIA
PARIS
PHILADELPHIA
PITTSBURGH
PRINCETON
RICHMOND
SAN FRANCISCO
SHANGHAI
SILICON VALLEY
SINGAPORE
WASHINGTON, D.C.
WILMINGTON

reedsmith.com