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Asset Management and Investment Funds Group

Legal and Regulatory Update

Regulators Provide Welcome Clarity Amid Continued Brexit Uncertainty

As 29 March looms with uncertainty still surrounding the type of Brexit scenario that will unfold, there have been a number of regulatory developments at EU, UK and Irish level, which should provide some welcome clarity in the event of a hard Brexit. Key amongst these are recent agreements and announcements with regard to delegation, the CP86 location requirement, marketing in the UK post-Brexit, and settlement.

DELEGATION

Both the UCITS and AIFM Directives permit third-country delegation of investment management under specified criteria and many Irish funds and management companies delegate the investment function to portfolio managers based in the UK that are regulated by the Financial Conduct Authority ("**FCA**"). However, Brexit threatened to disrupt this as delegation to a non-EU manager requires co-operation agreements to be in place between the relevant EU regulator and the regulator of the non-EU manager. On 1 February, the European Securities and Markets Authority ("**ESMA**") confirmed that it had agreed a Memorandum of Understanding, on behalf of the EU27 national regulators, with the FCA and so delegation of portfolio management from Irish funds to UK based portfolio managers can continue post 29 March, even in the event of a hard Brexit.

CP86 LOCATION RULE

On 4 February, the Central Bank of Ireland released a Notice of Intention regarding the location requirement for directors and designated persons of Irish fund management companies. This rule requires that a minimum number of directors and designated persons be EEA-resident (for example, at least half of the managerial functions should be performed by at least two EEA-resident designated persons).

The notice confirms that, in a hard Brexit scenario, the Central Bank will not immediately move to treat the UK as a third country for the purposes of this requirement.

Although the Central Bank has made it clear that this is a temporary measure while it considers the issue more fully, this confirmation that in the event of a hard Brexit it won't immediately require UK based directors and designated persons to be replaced by EEA based ones will come as a welcome clarification for the Irish management companies of international fund promoters whose UK based staff serve as directors and designated persons for those Irish entities.

UK AIFMS OF IRISH FUNDS

Additionally, the Central Bank has confirmed in the latest update to its AIFMD Q&A that an Irish authorised QIAIF will be permitted to designate a UK AIFM as its AIFM, provided that the QIAIF and its UK AIFM comply with the provisions of the AIF Rulebook that apply in the case of QIAIFs with "registered" or sub-threshold AIFMs. However, as the AIFM will be a non-EU AIFM, marketing of the QIAIF by the AIFM into other EU member states under the AIFMD passport will no longer be permitted and will instead be subject to member states' national private placement regimes.

MARKETING IN THE UK POST-BREXIT – TEMPORARY PERMISSIONS REGIME OPENS

On 7 January, FCA announced that its notification period under the temporary permissions regime ("**TPR**") for firms and funds had opened. The TPR provides a backstop in the event that there is no transition period and the passporting regime falls away upon a hard Brexit.

Accordingly, funds/fund managers may now start to notify the FCA of their intention to continue marketing funds in the

UK post-Brexit. There is no fee to make the notification and the FCA has advised that funds/fund managers should not wait for confirmation of a transition period prior to making their notification. The FCA does, however, advise that fund managers should submit their notification with a full list of the funds they wish to continue marketing and if it is anticipated that they will add funds to their notification before the window closes on 28 March, they should wait until they have a full list before submitting. Once submitted, no amendments are permitted to the notification and so funds/fund managers should be satisfied that all relevant funds are included in the submission prior to completing the notification. However, new UCITS sub-funds will be permitted to notify the FCA to enter the TPR post-Brexit provided that at least one sub-fund of the new sub-fund's umbrella has notified its intention to enter the TPR prior to 28 March 2019 (the date the notification period will close).

The notification must be made through the FCA's Connect system and the FCA has published some operational guidance on how to make the online notification.

Once a firm has received a temporary permission to continue marketing a fund in the UK it will be allotted a time period within which to apply for a new authorisation required to continue this marketing activity and submit its application. The FCA expects the first of these slots to be later in 2019, with the last timed towards the end of the temporary permissions period, currently expected to run for 3 years from the date of exit.

SETTLEMENT - EUROPEAN COMMISSION GRANTS TEMPORARY EQUIVALENCE TO UK CSDS

The European Commission has adopted a temporary equivalence decision ("Decision") under Article 25 of the Central Securities Depositories Regulation (EU/2014/909) in respect of UK authorised Central Securities Depositories ("**CSDs**"). This means that in the event of a hard-Brexit, UK CSDs, such as CREST, can continue to provide their services within the EU for a specified period. This is a welcome move for Irish securities market participants in particular. Ireland does not have an indigenous securities settlement system and accordingly most trades in Irish securities are settled in the UK via CREST. Therefore, the inability to use CREST post Brexit would have caused significant disruption to the Irish securities market.

The Decision entered into force on 20 December 2018 and, should the UK leave the EU without an agreed withdrawal agreement, will apply for two years from Brexit day (30 March 2019) until 30 March 2021. Following the adoption of the Decision, and agreement of a Memorandum of Understanding between ESMA and the Bank of England, UK CSDs may now apply for recognition from ESMA.

Additionally, in preparation for a potential "no-deal" Brexit, the Irish Government has published a general scheme of the Miscellaneous Provisions (Withdrawal of the United Kingdom from the European Union on 29 March 2019) Bill (the "**Bill**"). The Bill, which comprises 17 Parts, is intended to be consistent with and complementary to EU preparations for the UK's withdrawal from the EU. Part 7 of the Bill introduces legislative amendments to support the implementation of the European Commission's Decision and to extend the protections contained in the Settlement Finality Directive to Irish participants in relevant third country domiciled settlement systems.

Beneficial Ownership of Trusts Regulations: Implications for Irish Unit Trusts

On 29 January 2019, the Department of Finance published the European Union (Anti-Money Laundering: Beneficial Ownership of Trusts) Regulations (S.I. No 16 of 2019) (the "**Regulations**"). These Regulations, which were immediately effective, transpose Article 31 of the Fourth EU Money Laundering Directive ("**4MLD**") which requires trustees of express trusts to obtain and hold adequate, accurate and up-to-date information in respect of the trust's beneficial owners and to keep and maintain a beneficial ownership register. The Regulations apply to any express trust whose trustees are resident in, or which is otherwise administered in, Ireland, including where shares are held on trust under an express declaration of trust.

The Regulations apply to Irish collective investment schemes that are constituted as trusts and so introduce a new requirement for these funds' trustees to obtain the information in relation to beneficial owners and to maintain a beneficial ownership register. Irish funds constituted as investment companies and ICAVs are already subject to these beneficial ownership requirements (for more information on the beneficial ownership requirements for these corporate entities, please see our previous briefing here). The Regulations specifically provide that a "collective investment undertaking trustee" for funds that are constituted as trusts includes the manager and/or operator of the fund. Therefore, both the depositary and the fund manager are trustees for these purposes and so are responsible for compliance with the Regulations. Accordingly, fund managers and depositaries of Irish unit trusts should ensure that appropriate arrangements are in place between them with regard to obtaining

information on beneficial ownership and the maintenance of the beneficial ownership register.

WHO IS A BENEFICIAL OWNER?

In accordance with 4MLD, the Regulations provide that a beneficial owner is "any natural person(s) who ultimately owns or controls the customer and/or the natural person(s) on whose behalf a transaction or activity is being conducted". In the case of a trust this means all of the following:

- the settlor(s) - in an Irish unit trust this is the fund manager;
- the trustees(s) - in an Irish unit trust this is the depositary and the fund manager;
- the protector(s), if any - an Irish unit trust will not have a protector;
- the beneficiaries (or if they have not yet been determined, the class of persons in whose main interest the trust is established or operates), in an Irish unit trust these are the investors or class of investors in the unit trust; and
- any other natural person who exercises ultimate control over the trust by direct ownership, by indirect ownership, or by any other means.

In the case of an Irish unit trust, as neither the manager nor depositary will be natural persons, the relevant beneficial owners will be the fund's underlying investors, or at a minimum the class of investors (who are natural persons), as well as any other natural person who exercises ultimate control over the trust by direct or indirect ownership or by any other means. Unlike the regulations applying to registers for corporate beneficial ownership, there is no default position with regard to naming senior managing officials as beneficial owners where individual beneficial owners cannot be determined. Also, there is no guidance or thresholds with regard to determining the ultimate control of the trust.

WHAT ARE THE TRUSTEE'S OBLIGATIONS?

A trustee must take all reasonable steps to obtain and hold adequate, accurate and current information regarding the trust's beneficial owners. The trustee must therefore obtain the name, date of birth, nationality and residential address of each beneficial owner and enter this information on the trust's beneficial ownership register. The register must be called an "express trust (beneficial ownership) register".

The date upon which the beneficial owner is entered on the register as well as the date upon which a beneficial owner ceases to be such must be entered on the register. To ensure that the register is current, it must also be updated as soon as practicable when a person ceases to be a beneficial owner of the trust or there is any change which renders the details on the register incomplete or incorrect.

Where a trustee enters into an occasional transaction (which is any transaction that requires the application of customer due diligence measures under the Criminal Justice (Money Laundering and Terrorist Financing) Act 2010) or forms a business relationship with a designated person (such as a credit institution or other financial institution), it must inform the designated person in writing that it is acting as a trustee and, upon request, promptly provide all information identifying the beneficial owners of the trust. In the case of a class of beneficiaries, this requirement will be satisfied by specifying the class of persons that are beneficiaries or potential beneficiaries under the trust. The designated person must be notified within 14 days of the trustee becoming aware of any changes in these particulars.

WHO HAS ACCESS TO THE REGISTER?

Upon request a trustee must provide the Revenue Commissioners, the Central Bank of Ireland, the Minister for Justice or any other competent authority that the Minister may prescribe with timely access to the trust's register. This information may also be disclosed to any corresponding competent authority in another EU Member State. Further, under the Fifth EU Money Laundering Directive ("**5MLD**"), Member States are required to establish a central register of beneficial ownership of trusts, which will be accessible to competent authorities, Financial Intelligence Units (in Ireland, the Garda Síochána), obliged entities and any natural or legal person that can demonstrate a legitimate interest. This central register must be established by 10 March 2020. A publicly accessible central register of corporate beneficial ownership must also be established by 10 January 2020 (For more information on 5MLD, please see our previous briefings here and here).

RECORDS

A trustee must keep a record of the steps it has taken to identify the beneficial owners of the trust. These records must be retained for five years after the date that the final distribution under the trust is made and, subject to certain exceptions, must be destroyed at the end of this period.

OFFENCES

Failure to comply with the requirements is an offence liable on summary conviction to a fine of up to €5,000.

ACTIONS

The Regulations have been effective since 29 January 2019 and so managers of Irish unit trusts should now ensure compliance with the Regulations by:

- establishing and maintaining a register;
- ensuring that the relevant information is adequate, accurate and current;
- establishing processes around:
  - the regular review of the register to ensure its adequacy, accuracy and that it is current;
  - the making and timing of required notifications under the Regulations; and
  - record retention.

Central Bank Statement on Money Market Funds and Share Cancellation

The Central Bank issued a statement (jointly with Luxembourg's CSSF) on 11 January regarding the incompatibility of reverse distribution mechanisms, such as share cancellation, with the Money Market Funds Regulation (EU/2017/1131) ("**MMFR**"). The MMFR applied on 21 July 2018 with a transitional period for existing money market funds ("**MMF**s") until on 21 January 2019. Accordingly, those pre-existing MMFs should have submitted their applications and supporting documentation for authorisation as MMFR compliant funds to the Central Bank by this date. They were also required to submit details of their arrangements for ceasing the use of share cancellation. The Central Bank must make its authorisation decision by 21 March 2019, which effectively provides an extension to this date to confirm that they have ceased use of reverse distribution mechanisms. In the notice the Central Bank (and CSSF) require relevant funds to:

» provide a copy of the notice to its investors informing them that they are invested in a fund which is the subject of the notice;

» ensure all necessary and appropriate facilities are available for investors or prospective investors to obtain any required information from the fund regarding the subject matter of the notice;

» take such steps which in the opinion of the fund are appropriate to avoid a disorderly sale of fund assets; and

» confirm in writing to the Central Bank (or CSSF as applicable) by no later than 21 March 2019 that all use of share cancellation mechanisms has ceased.

Cross-border Distribution of Investment Funds

In March 2018, the European Commission ("**Commission**") proposed amendments to both the UCITS and AIFM Directives aimed at removing identified regulatory barriers to the cross-border distribution of investment funds. On 5 February 2019 political agreement on these proposals was reached. The key legislative changes will include a definition of "pre-marketing" under AIFMD, which will permit alternative fund managers to more easily test the appetite of potential professional investors in new markets; and harmonising the de-notification procedure. The final texts of the proposals have yet to be finalised and adopted by both the European Parliament and Council, but it is intended that these legislative proposals on cross border distribution will be agreed by Q2 2019.

PRIIPs – UCITS KID Exemption Extended to 2021

UCITS are currently exempted from having to produce a PRIIPs KID until 31 December 2019. However, agreement has been reached on a proposal to extend this exemption for UCITS by a further two years to 31 December 2021. The amendment was included in the proposed regulation on facilitating the cross-border distribution of collective investment funds, which received political agreement on 5 February 2019. It is expected that these legislative proposals on cross border distribution will be agreed by Q2 2019.

ESMA Consults on Liquidity Stress Testing for UCITS and AIFs

Liquidity risk in funds has and continues to be a subject of focus for both national and international regulators/authorities. In April 2018, the European Systemic Risk Board ("**ESRB**") published recommendations on how to address liquidity and leverage risk in investment funds. Included in these recommendations was a request that ESMA develop guidance for fund managers of both UCITS and AIFs with regard to liquidity stress testing ("**LST**") based on the stress testing requirements set out in AIFMD and how market participants carry out stress testing. Accordingly, ESMA has developed and launched (on 5 February) a public consultation on 14 draft guidelines ("**Guidelines**"). The Guidelines require that LST should:

» be tailored to the individual fund;

- reflect the most applicable risks to a fund;
- include stressed scenarios that are sufficiently extreme or unfavourable (yet plausible);
- sufficiently model how a manager is likely to act in times of stressed market conditions; and
- be embedded into the fund's overall risk management framework.

The Guidelines also provide that depositaries and how they should fulfil their obligations regarding liquidity stress tests. This guideline provides that depositaries should verify that a fund has documented procedures for its LST programme, which could include reviewing the UCITS RMP and/or AIF RMP to confirm that the manager carries out LST on the fund.

ESMA is requesting feedback on:

- the design of LST scenarios;
- the LST policy, including internal use of LST results;
- considerations for the asset and liability sides of fund balance sheets; and
- the timing and frequency for individual funds to conduct the LST.

The consultation will close on **1 April 2019**.