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# Asset Management and Investment Funds Group

*Legal and Regulatory Update*

## UCITS KIID: ESMA Clarifies Benchmark Disclosure Requirements

Building on its policy and supervisory convergence work on closet indexing and the impact this can have on fund costs and ultimately investor returns, ESMA has updated its UCITS Q&A to clarify certain past performance and benchmark disclosure requirements to be included in UCITS KIIDs.

### PAST PERFORMANCE DISCLOSURE

In any circumstance where a UCITS refers to an index as a benchmark in its investment objective and policies and will measure performance against that index (but does not intend to track that index), then the past performance of that index must also be provided in the relevant section of the KIID. Previously, ESMA had advised that where a UCITS only referred to an index in its investment objective and policies, for example, as an indication of the universe from which investments could be selected, and did not intend to track that index, then the past performance of that index did not have to be included in the KIID. The updated Q&A repeals this guidance and also provides that where a UCITS names a target or comparator in its investment objective and policies which the UCITS aims to outperform, the performance should be disclosed against the target or comparator, even if the comparator is not named a 'benchmark'. In addition, where the UCITS' target is the outperformance of an index over a certain period of time, e.g., over a number of years, the annualised performance of the benchmark index must be shown alongside that of the UCITS, even if the target is to beat the index over the specified time-period.

ESMA also requires that the performance disclosed in the KIID regarding a benchmark index should be consistent with the performance disclosure in other investor communications. In particular, these disclosures should be consistent across offering documents and marketing materials (including the prospectus), distribution channels and investor type.

### DISCLOSURE OF THE BENCHMARK INDEX IN THE INVESTMENT OBJECTIVE AND POLICIES

A UCITS KIID must contain certain key investor information in the "Objective and Investment Policies" section. The updated Q&A provides that this information must now include a clear statement as to whether or not the UCITS is actively or passively managed. Active UCITS which are managed in reference to an index must make this clear to investors and indicate how actively managed the UCITS is compared to the index. ESMA also recommends that UCITS, which are not managed in reference to a benchmark, should make this clear to investors with a suitable KIID disclosure.

The updated Q&A also expands upon the meaning of an active management approach which "includes or implies a reference to a benchmark". Although ESMA notes that it is ultimately the UCITS management company's responsibility to determine whether or not a UCITS is managed in reference to a benchmark index, the updated Q&A states that:

*"a UCITS managed in reference to a benchmark is one where the benchmark plays a role in the management of the UCITS, for example, in the explicit or implicit definition of its portfolio composition and/or performance objectives and measures".*

ESMA has included the following non-exhaustive examples of these portfolio composition and performance objectives:

### PORTFOLIO COMPOSITION

» The UCITS uses a benchmark index as a universe from which to select securities. This applies even if only a minority of securities listed in the index are held in the portfolio and the weightings of the UCITS' portfolio holdings diverge from their equivalent weighting in the index.

» The UCITS portfolio holdings are based upon the holdings

of the benchmark index. For example:

- the individual holdings of the UCITS' portfolio do not deviate materially from those of the benchmark index; and
- monitoring systems are in place to limit the extent to which portfolio holdings and/or weightings diverge from the composition of the benchmark index.

- The UCITS invests in units of other UCITS or AIFs in order to achieve similar performance to a benchmark index.

### PERFORMANCE MEASURES

- Performance fees are calculated based on performance against a reference benchmark index.
- The UCITS has an internal or external target to outperform a benchmark index.
- Contracts between the management company and third parties, such as the Investment Management Agreement covering delegation of investment management, or between the management company and its directors and employees, state that the portfolio manager must seek to outperform a benchmark index.
- The individual portfolio manager(s) receive(s) an element of performance-related remuneration based on the fund's performance relative to a benchmark index.
- The UCITS is constrained by internal or external risk indicators that refer to a benchmark index (e.g. tracking error limit, relative VaR for global exposure calculation).
- Marketing issued by the UCITS management company to one or more investors or potential investors shows the performance of the fund compared with a benchmark index.

ESMA has also provided guidance, and sample disclosure wording, with regard to providing investors with sufficient information in relation to an actively managed UCITS' degree of freedom from a benchmark index (where that UCITS' investment approach includes or implies a reference to a benchmark index). To do this, investors should be provided with an indication of how actively managed the UCITS is, compared to its reference benchmark index. When indicating the degree of freedom in the KIID, the new Q&A provides that a UCITS' management company should, at a minimum, consider the following elements:

- the description of the underlying investment universe of the UCITS should indicate to what extent the target investments are part of the benchmark index or not; and
- the KIID should describe the degree or level of deviation of the UCITS with regard to the benchmark index, thereby considering, where applicable, the quantitative and/or qualitative deviation limitations underlying the investment approach as well as the narrowness of the investment universe. If necessary for investor understanding, a UCITS may also in this context, disclose quantitative metrics.

However, unless stricter requirements specific to a Member State apply, UCITS that are actively managed in reference to a benchmark index are not required to numerically quantify the degree of freedom by, for example, outlining the expected tracking error, active share, or other metrics in order to provide a quantitative indication. Nevertheless, where the UCITS management company believes such information will assist investor understanding, it may do so by providing explanations in language sufficiently comprehensible to retail investors.

Sample wording addressing these two points has also been included in the Q&A.

The new guidance means that only a very small proportion of UCITS may not be considered to be managed in reference to a benchmark. All UCITS, in particular actively managed UCITS, will therefore need to carefully review their KIIDs to determine what changes will be required to comply with this new guidance. Any required changes to the KIID in order to incorporate ESMA's guidance must be made as soon as practicable, or by the next KIID update following the publication of the Q&A (i.e. the next KIID update post 29 March 2019).

If you would like to discuss the foregoing, or require any assistance in assessing your requirements, please feel free to contact a member of our team.

## New Regulations on Corporate Beneficial Ownership Published

On 22 March 2019, the European Union (Anti-Money Laundering: Beneficial Ownership of Corporate Entities) Regulations 2019 (the "**Regulations**") were published. The Regulations revoke the previous regulations made in November 2016 (S.I 560 of 2016), which gave effect to the requirement for relevant entities to establish and maintain a corporate beneficial ownership register. Therefore, investment funds constituted as companies and ICAVs should already be maintaining this register. The Regulations maintain this requirement and also provide for the creation of a central register of beneficial ownership ("**RBO**"), which EU Member States are required to put in place before 10 January 2020. The Regulations were immediately effective, however Part 3 with regard to the establishment of the central register and the submission of relevant information thereto will not take effect until 22 June 2019. Thereafter, entities will have five months

from that date to submit their information to the registrar, which in Ireland is the Registrar of Companies ("**Registrar**"). Following the publication of the Regulations, the Registrar advised that it will be contacting companies about their filing obligations in the coming weeks and an RBO website will be launched on 29 April. Information on the RBO can be found here and a template setting out the data to be filed with the RBO is provided here.

Although ICAVs are included in the definition of "relevant entity" for the purposes of the filing obligation under the Regulations, it is likely that a separate central register will be established to deal with the beneficial ownership information for ICAVs. Further clarification on this point has been sought from the relevant government department and we will keep you updated on this point. (For more information, please see a more detailed briefing from our Financial Regulation and Company Compliance and Governance teams here).

## Central Bank Reminds Firms of their Fitness and Probity Obligations

The Central Bank has written to all regulated financial service providers ("**Firms**"), including investment funds, to remind them of their obligations as a firm under the Central Bank's fitness and probity regime and the standards ("**Standards**") issued in accordance with that regime. The Central Bank reiterates that Firms have an ongoing obligation to ensure that their senior and other key personnel comply with the Standards and to ensure that they do not permit a person to perform a controlled function role ("**CF**") unless they are "satisfied on reasonable grounds" that that person complies with the Standards. The Central Bank's letter highlights specific issues that have arisen and which Firms must address to ensure they comply with the fitness and probity requirements, including:

- Failure to conduct due diligence on an ongoing basis to ensure persons performing CF roles are complying with the Standards;
- Failure to report identified fitness and probity issues or concerns to the Central Bank; and
- Instances where individuals have not provided material information on their applications to the Central Bank for approval to senior roles.

To address these shortcomings, the Central Bank recommends that at a minimum Firms should:

- Require persons performing CF roles to notify them of any changes in their circumstances that might be material to their fitness or probity;
- Properly assess whether or not an individual still meets their obligations under the Standards;
- Obtain, at least annually, confirmation that those performing CF roles are aware of the Standards and agree to abide by them; and
- Notify the Central Bank without delay of any fitness and probity concerns.

The Central Bank requires Firms and their boards to examine the issues outlined in its letter and to review their own fitness and probity policies, procedures and practices and address any shortcomings. Firms must be able to demonstrate how the issues raised were considered and explain and provide evidence of any remedial actions taken.

## Irish UCITS and AIFs May Now Invest in Chinese Bonds via Bond Connect

On 29 March 2019, the Central Bank updated its UCITS and AIFMD Q&As to reflect that Irish UCITS and AIFs may acquire Chinese bonds through the Bond Connect infrastructure, provided that the depository of the UCITS, or an entity within its custodial network, can ensure that it retains control over the bonds at all times. The depositary is also required to review the Bond Connect infrastructure arrangements and to keep these under review to ensure that it can fulfil its legal obligations.

# Leverage Calculation: ESMA Updates AIFMD Q&A

On 29 March 2019, ESMA updated its AIFMD Q&A regarding the calculation of leverage.

The new Q&As clarify that:

» the calculation of leverage exposure of an AIF resulting from a short-term interest rate future should not be adjusted for the duration of the future; and

» an AIFM should calculate the leverage of each AIF that it manages as frequently as necessary to ensure that the AIF can remain in compliance with leverage limits at all times. Therefore, ESMA notes that leverage should be calculated at least as often as the NAV is calculated, or more often if required. Circumstances which may lead to an increased frequency of leverage calculation include:

» material market movements;

» changes to portfolio composition; and

» any other factors the AIFM believes require calculation of leverage more frequently than NAV in order for the AIF to remain in compliance with leverage limits at all times.

# FCA Extends Temporary Permissions Regime Notification Window

On 7 January, the notification period under the FCA's temporary permissions regime ("**TPR**") for firms and funds 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 could notify the FCA of their intention to continue marketing funds in the UK post-Brexit. The closing date for notifications was originally 28 March, however in light of the agreed delay to exit day, the FCA has extended this deadline to **11 April**.

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 "landing slots" for authorisation/recognition to be granted in October to December 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.

# Benchmarks Regulation

### ESMA CLARIFIES EFFECT OF HARD-BREXIT ON UK AUTHORISED BENCHMARK ADMINISTRATORS

In the event of a no-deal Brexit, previously authorised UK benchmark administrators will become third country administrators and will be removed from the ESMA register of EU administrators. However, given that the Benchmarks Regulation provides for a transition period until January 2020 during which supervised entities (including UCITS, UCITS management companies and AIFMs) can continue to use third country benchmarks, these entities can continue to use benchmarks provided by a UK administrator.

Similarly, where third country benchmarks were recognised or endorsed in the UK prior to exit day (and so included on the ESMA register), these benchmarks will also be deleted from the register. However, as the transitional period also applies to these third country benchmarks, supervised entities may continue to use these benchmarks during the transitional period.

ESMA provided this clarification in a public statement regarding the impact of a hard-Brexit on the Benchmarks Regulation (and certain key provisions of MiFID II/MiFIR).

### CENTRAL BANK SETS OUT AUTHORISATION REQUIREMENTS FOR BENCHMARK ADMINISTRATORS

The Central Bank has published a Key Facts Document outlining its information requirements in respect of applications for authorisation/registration as benchmarks administrators. The formal application forms and the Central Bank's supervisory requirements are expected to be published on its website soon.

# Outsourcing

Outsourcing is set to remain an area of key focus for global regulators throughout 2019. As part of its first annual work programme, IOSCO has announced that it will review its existing Principles on Outsourcing to determine whether or not they remain fit for purpose in light of new technological developments and the increased use of third party service providers. The EBA has also published its revised guidelines on outsourcing that will enter into force on 30 September 2019 and are likely to prove instructive in other sectors, including asset management.

Closer to home, the Central Bank also remains focused on outsourcing. At a recent industry event (Remarks delivered at Funds Europe, European FundTech Lab event; 26 March 2019), Gerry Cross, Director, Financial Regulation – Policy & Risk reiterated the Central Bank's views on outsourcing and its minimum requirements as set out in its Discussion Paper on Outsourcing ("**DP8**"). He also referred to the particular risk posed by outsourcing to cloud service providers. Addressing the funds' sector specifically, he noted that "*under the UCITS and AIFMD frameworks, no distinction is drawn between the terms 'outsourcing' or 'delegation'*" and as set out in DP8, "*the Central Bank is clear that no difference may be inferred where these terms are used*". He noted that no matter whether it is termed delegation or outsourcing, the arrangements must be subject to effective due diligence, appropriate oversight arrangements and good governance to ensure that any tasks not performed by the regulated entity are carried out to a high standard, and reminded the audience that the ultimate responsibility for the outsourced service or function lies with the regulated entity (i.e. the board/senior management). He also referred to the CP86 requirements around delegation and stated that the Central Bank will be reviewing how management companies have implemented these requirements, and will consider whether the outcomes sought are being achieved and whether further guidance may be needed.

# SFTR Reporting Obligation

Article 4 of the Securities Financing Transactions Regulation Regulation ((EU) 2015/2365) (SFTR)) provides that SFT counterparties must report details of SFT transactions to a trade repository. This obligation applies on a phased basis depending on the type of counterparty and when the Level 2 measures implementing the reporting obligation are adopted. UCITS and AIFs that are SFT counterparties are also subject to the reporting obligation and their manager/AIFM (where externally managed) are obliged to report.

On 22 March, these Level 2 measures were published in the Official Journal of the EU and set out various requirements with regard to the obligation and the type of information that should be reported. The implementing regulation entered into force on 11 April 2019 and accordingly the commencement date of the reporting obligation for UCITS and AIFs is **11 October 2020**. Investment firms must report from 11 April 2020.

# MiFID/MiFIR: ESMA Updates its Investor Protection Q&A

ESMA has published (28 March) new Questions and Answers (Q&As) and updates on the implementation of investor protection topics under MiFID II/MiFIR. The Q&As provide new answers on:

- Provision of investment services and activities by third-country firms - Reverse solicitation
- Product governance - Target market of CoCo-bond funds
- Suitability report - Use of generic statements
- Information on costs and charges
  - Level of individualisation of ex-ante information
  - Conditions to be met to use costs grids/tables for ex-ante information
  - Ex-ante information for the service of portfolio management
  - Terminology
  - Taxes to be included in the ex-ante and ex-post costs and charges information
- Other issues – Durable medium
- Best Execution - RTS 27 reporting requirements for market makers and other liquidity providers

ESMA has also updated two Q&As on:

- Suitability report: availability on firm's website; and
- Information on costs and charges - Use of products' costs presented in the PRIIPs KID.