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Asset Management and Investment Funds Group

Legal and Regulatory Update

Central Bank Issues Brexit Reminder for Funds

With Brexit fast approaching, the Central Bank has written to the boards of funds and fund management companies (including self-managed investment funds) ("**Fund Companies**") to remind them of their responsibility to ensure that they and/or all funds under their management are adequately prepared for the impact of Brexit.

In its industry communication (6 August 2019) the Central Bank reminded Fund Companies to ensure that any updates to fund documentation (prospectus, supplements, agreements etc.) required as a result of Brexit are submitted to the Central Bank by **30 September 2019**. The Central Bank notes that these Brexit-related updates may include amendments to the list of regulated markets to remove references to the United Kingdom as a European market, or policy updates as required to clarify the geographical focus of a UCITS or Retail AIF.

In a separate Brexit-related communication, the Central Bank highlighted the importance of liquidity risk management and liquidity stress testing emphasising that the responsibility for liquidity risk management, which includes compliance with all legal and regulatory obligations in respect of the liquidity of each fund under management, rests with the boards of Fund Companies, individual directors and the relevant designated persons. The Central Bank therefore requires that:

- all board members, relevant designated persons and relevant responsible persons within delegate fund service providers are made aware of the Central Bank's communication;
- the board, relevant director and designated persons, on an ongoing basis, assess the liquidity position of each fund under management to ensure that the liquidity of the investment portfolio remains in line with that fund's redemption policy, taking into account investors redemption demands; and
- fund documentation is clear, accurate and consistent with legal and regulatory requirements.

The Central Bank also notes that it will continue its work on monitoring investment fund liquidity, which it first began in January 2019 as part of its overall Brexit preparedness work.

Central Bank Closet Indexing Review: Issues and Actions for Boards

Following the completion of its closet indexing review, the Central Bank has issued an industry letter (18 July 2019) highlighting the key issues identified in the course of this review and the actions that UCITS management companies (including self-managed investment companies) should take to mitigate these issues.

The key findings from the review included:

- Investors not always being provided with sufficient or accurate information about the investment strategy in the prospectus and KIID. The Central Bank identified instances where:
  - the disclosures did not accurately describe the nature of the investment strategy (e.g. active v passive);
  - the information in the prospectus and KIID was

inconsistent with other fund documentation including marketing materials; and

- the marketing materials explained the investment strategy more clearly than the prospectus and KIID.

- Poor governance and controls by boards of UCITS management companies including:
  - insufficient oversight of offering documents;
  - insufficient evidence of challenge regarding the chosen investment strategy;
  - approval of management fees in excess of the targeted outperformance of the benchmark;
  - insufficient oversight of distribution and investment strategy; and
  - lack of regular assessment by the board to determine whether the performance of the UCITS was reflective of the expected active management.
- Relevant benchmark disclosures not being included in the past performance section of the KIID.
- Instances where multi-manager UCITS consistently delivered a performance similar to an index.

The Central Bank has stated that it is concerned by the transparency issues it identified in its review and reminds boards of their responsibility for the disclosure and implementation of the investment policy for each managed UCITS as set out in the prospectus. The Central Bank's communication should be brought to the attention of all directors, Designated Persons and responsible persons within fund service providers and UCITS management company boards must now:

- actively consider the contents of the Central Bank's letter;
- review and revise the prospectus and KIIDs accordingly. Any necessary updates must be provided to the Central Bank by **31 March 2020**;
- consider the accuracy of the content of the prospectus and KIID and ensure that there is:
  - compliance with all applicable legislative requirements and guidance (including ESMA's benchmark KIID Q&A issued in March 2019);
  - consistency between investor documentation;
  - relevant disclosure where the fund is managed in a constrained manner; and
  - where a fund is managed with a performance target, this must also be disclosed in the prospectus and KIID.

Further, the board's assessment of the investment manager's annual presentation required under the Central Bank's Fund Management Company Guidance ("**CP86**") should consider if the UCITS has delivered on its stated objective and remains a viable and suitable investment for investors. This review should be documented and should include an assessment of the UCITS' performance, the fee structure and the investor base. Fees charged on all share classes within each UCITS should also be reviewed to assess whether they are appropriate for the targeted level of outperformance of the UCITS against its benchmark.

Central Bank Updates its Guidance on UCITS Financial Indices

The Central Bank has made a further revision to its guidance on the use of financial indices by UCITS for investment or efficient portfolio management purposes. The previous update to the guidance in October 2018 introduced a self-certification obligation in respect of financial indices used by a UCITS, with a pre-approval submission to the Central Bank required for certain types of indices.

Under this regime, the UCITS was required to assess each financial index that it intended to use to ensure that it complied with all relevant regulatory requirements. Once this determination had been made, a responsible person (a director of the UCITS Management Company/SMIC) was required to certify to the Central Bank that the relevant regulatory requirements were met when the UCITS sought authorisation from the Central Bank. Where a previously authorised UCITS/ sub-fund proposed to use a financial index, the certification was required to be provided by way of a post-authorisation submission.

On 23 July, the Central Bank issued updated guidance ("**Guidance**") amending this certification process and clarifying when an index certification is not required to be submitted. The Guidance provides that an index certification is not required where:

- the index is used for tracking or replication, investment or efficient portfolio management purposes and on a look-through basis the UCITS could invest directly in the constituents of the index/indices as permitted under the UCITS Regulations (for example, the "5/10/40" rule);
- market movements or other events may cause the weightings of a financial index to change so that it no longer complies with the "5/10/40" rule. Where this happens and on the basis that the UCITS confirms as part of its authorisation/post-authorisation process that the index meets the regulatory requirements (i.e. it is comprised of eligible assets and complies with the

"5/10/40" rule), the financial index will be deemed to meet index criteria set out in the Guidance; or

» an index is used solely as a performance benchmark.

A UCITS that proposes to use a financial index for which there is no requirement to submit an index certification should state, when making the application for authorisation to the Central Bank, that such index meets the regulatory requirements. The absence of such a statement will result in the Central Bank querying the use of the index, and requesting the relevant certification, thus delaying the authorisation process. The Guidance is silent about what approach should be taken by existing UCITS that do not have the ability to make this statement through the authorisation process and it is hoped this will be clarified in further guidance from the Central Bank.

The revised Guidance is partly in response to industry feedback. It should reduce the volume of self-certifications that need to be submitted to the Central Bank for UCITS to allow the use of indices that are sufficiently diversified and reference UCITS-eligible assets. It does not remove the need to submit a self-certification where the index does not meet the diversification requirements or references UCITS-ineligible assets (e.g., commodities indices).

It is important to remember that UCITS must still assess any proposed indices prior to use to determine whether they meet the relevant regulatory criteria. These assessments should be appropriately documented and retained, as the Central Bank may carry out spot checks on a UCITS' compliance with the requirements. Where the Central Bank selects an index for assessment all relevant information must be provided immediately upon request.

UCITS Performance Fee Rules Set to be Standardised

Building on its policy and supervisory convergence work on investment fund fees, ESMA is consulting on draft guidelines on UCITS performance fees ("**Guidelines**"). This follows from its 2018 analysis of performance fee structures throughout the EU, which found that there was considerable divergence between national regulators' practices regarding the permitted structure and payment of UCITS performance fees. The Guidelines, which will apply to UCITS management companies and self-managed investment companies as well as national regulators provide for common criteria to promote supervisory convergence in the following five areas:

» general principles on performance fee calculation methods. The Guidelines provide that the performance fee calculation method should include at least: the reference indicator used to measure the relative performance of the fund, the crystallisation period and date, the performance reference period, the performance fee rate, the performance methodology and the computation frequency;

» consistency between the performance fee model and the fund's investment objectives, strategy and policy;

» frequency of performance fee crystallisation and payment;

» the circumstances in which a performance fee should be payable; and

» disclosure of the performance fee model.

Many of ESMA's proposals are provided for in the Central Bank UCITS Regulations 2019, which codified the Central Bank's former guidance on performance fees and introduced a minimum crystallisation frequency. Accordingly, performance fees may now only crystallise and be paid once per annum. There is an 18 month grandfathering period for funds in existence as at 27 May 2019 (the date the Central Bank UCITS Regulations 2019 took effect) to comply with this requirement. Notably, the Guidelines provide that a minimum crystallisation frequency is not compatible with a "fulcrum fee model" and ESMA is consulting on whether other performance fee methodologies, such as the "high-watermark model" should also be exempted from this requirement.

In its Feedback Statement to CP119 (its consultation on updating and consolidating the previous Central Bank UCITS Regulations), the Central Bank stated that it does not agree that separate crystallisation practices should apply where a UCITS uses the high-watermark methodology. Therefore, it remains to be seen whether there will be a divergence between the Central Bank's approach and ESMA's final Guidelines.

With regard to disclosure, ESMA is proposing that:

» the main elements of the performance fee calculation method (as set out in guideline 1) should be indicated in the prospectus; and

» the periodic reports of the UCITS and any other ex-post information (such as marketing materials) should indicate, for each relevant share class, the impact of the fees over the crystallisation period, by clearly displaying: (i) the actual amount of performance fees charged and (ii) the performance fees expressed as a percentage of the share class NAV.

The consultation will close on **31 October 2019** and it is likely that ESMA will finalise the Guidelines in Q4 2019 or early Q1 2020 with a twelve-month grandfathering period applying for funds already operating performance fees. The end of this grandfathering period should therefore coincide with the end of the transitional arrangements under the Central Bank UCITS Regulations 2019 (27 November 2020) and UCITS and UCITS management companies should now review their performance fee arrangements to ensure compliance with both the Central Bank's and ESMA's requirements.

Central Bank UCITS Q&A Update

On 15 July 2019, the Central Bank published the 27th edition of its UCITS Q&A.

As a result of the changes introduced by the updated Central Bank UCITS Regulations 2019, the following Q&As in respect of accounts have been amended:

» ID 1070 regarding the format of the second half-yearly accounts is no longer relevant and has been deleted;

» ID 1072 regarding the two month filing period for half yearly accounts is also no longer relevant and has been deleted; and

» ID 1071 has been updated to clarify that the minimum capital requirement report must be included with the annual audited accounts and first set of half yearly accounts only.

The Central Bank UCITS Regulations 2019 (Regulation 98) provide that the second set of accounts for UCITS management companies and depositaries should cover the full 12 months of the financial year (rather than the second six months of the financial year) and these accounts must be filed with the Central Bank within one month of the year-end.

Additionally, ID 1087, which refers to the exemption for UCITS from producing a PRIIPs KID, has been updated to reflect the extension of this exemption until 31 December 2021. The exemption was provided for in the Regulation on Cross-border distribution of investment funds, which was published in the Official Journal of the EU on 12 July 2019 and applied (with the exception of certain provisions) from 1 August 2019.

Central Register of Beneficial Ownership of Companies Now Live

The Central Register of Beneficial Ownership of Companies and Industrial and Provident Societies ("**RBO**") officially launched on 29 July 2019, following important clarifications in relation to the requirement to provide PPS (Irish tax) numbers for beneficial owners.

Under the European Union (Anti-Money Laundering: Beneficial Ownership of Corporate Entities) Regulations 2019 ("**Regulations**") relevant entities must, in addition to collecting the name, date of birth, nationality, residential address and the nature and extent of the interest held in respect of beneficial owner, also collect the PPS number of that beneficial owner (if they have one). This information must be submitted to the Registrar of Beneficial Ownership of Companies and Industrial Provident Societies ("**Registrar**") for inclusion on the RBO by 22 November 2019.

For beneficial owners who do not already have a PPS number, for example non-Irish resident directors who have not registered for Irish tax, the Registrar has clarified that the Form BEN2 (Declaration as to Verification of Identity) will be the method to be used to verify the person's identity. Only one Form BEN2 will be required in respect of each beneficial owner and once this has been processed successfully and an RBO transaction number issued by the Registrar, that number can be used for making future beneficial ownership filings for that person.

The Form BEN2 contains the name, date of birth, nationality and address of the beneficial owner. The beneficial owner must solemnly declare this information to be correct and true and have this declaration verified, witnessed and signed. Once completed and signed by beneficial owner and a witness (e.g. a Notary Public), the Form BEN2 will be uploaded to the RBO Portal. The Form BEN2 cannot be used if the beneficial owner has a PPS number and it will be an offence for a company not to provide a PPS number for a beneficial owner who has one, or to upload a Form BEN2 for a beneficial owner who has a PPS number. The Form BEN2 will be used by the RBO for identity verification purposes only, and will not be accessible to any third party. Additionally, public access to the RBO, known as "Tier 2" access, is restricted and accordingly the date of birth and address of the beneficial owner will not be visible. Updated FAQs are available on the RBO website.

NOTE ON ICAVS

Although ICAVs are corporate entities, the Registrar is not maintaining the central register of beneficial ownership of ICAVs and further clarity is required with regard to who will maintain this register. Nonetheless, ICAVs have a requirement under the Regulations to establish and maintain their own beneficial ownership registers and to submit this information for inclusion on a central register. Notwithstanding that there is no central register for beneficial ownership of ICAVs yet available, funds that are established as ICAVs should begin preparing for this requirement.

For more information on the RBO requirements, please see our Financial Regulation Group's article.

Money Market Funds: ESMA Finalises Stress Testing and Reporting Guidelines

On 19 July 2019, ESMA published final reports on guidelines on stress testing and reporting requirements under the Money Market Funds Regulation (EU/2017/1131) ("**MMFR**").

STRESS TESTING

Under the MMFR, money market funds ("**MMF**") (or their managers) are required to conduct regular stress tests as part of their risk management and regulatory disclosure obligations. Therefore, each MMF must have stress testing procedures in place to identify stress events, or future changes in economic conditions, and to assess the impacts these different scenarios may have on the MMF. These stress tests should be based on objective criteria and consider the effects of severe plausible scenarios.

ESMA is required to produce guidelines establishing common reference parameters for these stress test scenarios, which must be updated at least annually to take account of the latest market developments. ESMA issued its first set of guidelines in March 2018 and following a further consultation in September 2018 has published updated guidelines. The revised guidelines now

include additional stress test scenarios in relation to hypothetical changes in MMFs':

» liquidity levels;

» credit and interest rate risks;

» redemptions levels;

» widening/ narrowing of spreads among indexes to which interest rates of portfolio securities are tied; and

» macro-economic shocks.

REPORTING

As noted above, MMFs (or their managers) are expected to measure the impact of the common reference stress test scenarios as specified in the guidelines. Pursuant to Article 37 of the MMFR, the results of these stress tests (together with additional prescribed information) must be included in the quarterly reports that they must submit to their national regulator. (The frequency of reporting is annual in the case of a MMF whose assets under management in total do not exceed €100 million, but the MMF is also allowed to report quarterly). The additional information to be reported includes:

» general characteristics, identification of the MMF and the MMF manager;

» type of MMF;

» portfolio indicators (NAV, WAL,WAM, liquidity indicators etc...); and

» information on assets/liabilities.

The first quarterly report is due by the end of Q1 2020 and ESMA's guidelines on reporting provide guidance on completing the prescribed reporting template. There is no requirement to retroactively provide historical data for any period before this reporting start date. MMFs (or their managers) should ensure that they are conducting the required stress tests in accordance with the guidelines and have all the necessary information required to complete the stress testing field in the quarterly report.