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Asset Management and Investment Funds Group

Legal and Regulatory Update

CP86 Implementation Reviews: Phase 2 Underway

On 21 June 2019, the Central Bank took the first step in its well-publicised review of the implementation of its Fund Management Company Guidance ("**CP86**") and issued a Fund Management Company Guidance Questionnaire ("**Questionnaire**") to the Chairs of all fund management companies (including self-managed investment funds).

The Questionnaire comprised seven sections, covering:

» Governance and the Business Model;

» Delegate Oversight;

» Organisational Effectiveness;

» Directors' Time Commitments;

» Managerial Functions;

» Operational Issues; and

» Procedural Matters.

The deadline for completion and submission of the Questionnaire to the Central Bank was 5 July 2019, with the Central Bank noting that its analysis of the responses to the Questionnaire would be followed up with desk-based reviews and onsite inspections of selected firms.

In August 2019, the Central Bank commenced its desktop reviews, which appear to be initially focused on organisational effectiveness, and the fund risk management and investment management functions.

As part of these desktop reviews, the Central Bank has requested a number of fund management companies to provide it with information related to these three managerial functions, including:

» board documentation evidencing discussion of any fund underperformance;

» reports of designated persons ("**DPs**") for investment management and fund risk management;

» annual presentations by the DP for investment management on fund performance;

» reports following any onsite visits to service providers;

» schedules of due diligence visits on investment managers and due diligence carried out on most recently appointed investment manager; and

» details of key performance indicators triggering escalation of matters by these DPs to the board.

Fund management companies that are selected for further on-site inspections following the desktop review will be formally contacted by the Central Bank in due course.

New Liquidity Stress Testing Rules for Investment Funds

Fund liquidity looks set to remain a regulatory and supervisory priority at both domestic and EU level over the coming year. In an industry letter issued on 7 August 2019, the Central Bank highlighted the importance of liquidity risk management and liquidity stress testing in investment funds and, at EU level, ESMA has published its final guidelines on liquidity stress testing in UCITS and AIFs ("**Guidelines**").

The Guidelines apply to fund managers and provide guidance on how they should carry out liquidity stress tests on the individual funds that they manage and how depositaries should fulfil their obligations regarding these stress tests. The Guidelines are supplementary to the requirements on liquidity stress testing ("**LST**") in the AIFM and UCITS Directives and may be applied proportionately, having regard to the nature, scale and complexity of each fund. The Guidelines apply to UCITS and AIFs, with ESMA clarifying that this includes those funds established as money market funds, ETFs, and leveraged closed-ended AIFs*.

The Guidelines require fund managers to stress test the assets and liabilities of the funds they manage, which includes having regard to redemption requests by investors. Managers should be aware of the liquidity risk of the funds they manage and use stress testing as a tool to mitigate this risk. Under the Guidelines, fund managers must:

- integrate LST into a fund's risk management framework and LST should be subject to appropriate governance and oversight;
- have a strong understanding of liquidity risks and a fund's overall liquidity profile;
- develop LST models, ensuring that the LST provides information enabling follow-up action;
- adapt the LST to each fund;
- include an LST policy in the UCITS and/or AIF risk management process. This policy should be kept under review and the LST adapted as appropriate. This policy should include at a minimum:
  - a statement of ownership of the policy and the management function responsible for its performance;
  - a clear definition of the role of senior management in the LST process;
  - the interaction of the LST policy with other liquidity risk management procedures, including the fund manager's contingency plans and the portfolio management function;
  - a requirement for regular internal reporting of LST results specifying the frequency and recipients of the report;
  - provision for periodic review, documentation of the results and a procedure for amending the policy where required by the review;
  - the funds subject to LST;
  - initial validation of the LST models and assumptions underpinning them, which should be performed independently from portfolio management (though not necessarily by an entity/person external to the manager);
  - the types and severity of stress test scenarios used and the reasons for selecting those scenarios;
  - the assumptions used relating to data availability for the scenarios, their rationale and how frequently they are revisited; and
  - the methods for liquidating assets, including the limitations and assumptions used;
- carry out LST at least annually, although ESMA recommends that it is conducted quarterly, unless a higher or lower frequency is justified by the characteristics of the fund. This explanation should be noted in the LST policy. Ad-hoc LST should be undertaken as soon as practicable if a material risk to fund liquidity is identified by the manager and requires being addressed in a timely manner. ESMA has included examples of factors that fund managers should take into account in deciding on the appropriate LST frequency to apply. These include:
  - the liquidity of the fund and any change in the liquidity of the assets;
  - whether the fund is open-ended or closed-ended; and
  - the redemption policy and use of liquidity management tools;
- notify national regulators of material risks and the actions taken to address them; and
- during product development be able to demonstrate to their regulator that a fund will remain sufficiently liquid during normal and stressed circumstances.

The Guidelines also require depositaries to verify that a fund has documented procedures for its LST programme, which could include reviewing the UCITS and/or AIF risk management process to confirm that the manager carries out LST on the fund. However, a depositary does not need to replicate or challenge the LST performed by a manager.

Further, regulators may request submission of the fund manager's LST in order to demonstrate that the fund is likely to comply with applicable rules, including those regarding the fund's ability to meet redemption requests in normal and stressed conditions. Regulators will also have the discretion to request information from fund managers regarding their LST models and the results of their stress tests. Therefore, fund managers should start reviewing their overall liquidity management processes and preparing to comply with the Guidelines in advance of their application on **30 September 2020**.

Additionally, ESMA has developed a stress simulation

*In the case of money market funds, the scope is limited to those aspects of the Guidelines that are not already covered by the Money Market Funds Regulation (namely; the design of LST models, the LST policy, governance principles for LST, understanding liquidity risk and the depositary requirement). For ETFs, the Guidelines apply in addition to ESMA's Guidelines on ETFs and other UCITS Issues. However, in the case of ETFs LST should be adapted to take into account the specificities of ETFs such as the role of authorised participants, redemption models and replication models.

framework for the investment funds sector. ESMA will use this stress simulation framework as part of its regular risk monitoring to identify risk and assess possible adverse scenarios that might impact the EU fund industry. Regulators can use this methodology to simulate stress situations for different segments of the funds industry.

Commenting on the framework, ESMA Chair, Steven Maijoor stated that:

"The stress simulation framework is a key element of ESMA's stress testing strategy, which also includes guidelines on liquidity stress testing and on money market fund stress testing. The resilience of the fund sector is of growing importance as it accounts for an increasing part of the EU financial system.

"This framework will be an important tool for supervisors to assess risks in the asset management industry, as the methodology developed by ESMA can be applied across the industry's different sectors."

Central Bank Updates

Recent Central Bank publications of interest include:

AML GUIDELINES FOR THE FINANCIAL SECTOR

The Central Bank has published (6 September) its final Anti-Money laundering and Countering the Financing of Terrorism Guidelines for the Financial Sector ("**AML Guidelines**"). The Central Bank consulted on the AML Guidelines, which supplement the requirements of the Criminal Justice (Money Laundering and Terrorist Financing) Acts 2010-2018 (the "**Acts**") in CP128, and it has also published its feedback statement to that consultation. The Guidelines set out the Central Bank's expectations with regard to its existing requirements as well as the additional obligations imposed by the Acts.

CP 130 ON TREATMENT, CORRECTION AND REDRESS OF ERRORS IN INVESTMENT FUNDS

The Central Bank has published (9 September) a consultation on a regulatory framework to establish rules and guidance regarding the Treatment, Correction and Redress of Errors in Investment Funds ("CP 130"). In CP 130, the Central Bank is proposing a framework comprised of three distinct components:

» **Treatment** – how errors should be treated when they arise, including when such errors should be considered as material;

» **Correction** – how errors should be corrected, including what reporting and notification obligations should apply; and

» **Redress** – how the fund and / or investors should be appropriately rectified following an error.

"Appropriately Rectified" for these purposes means taking any necessary action to restore the fund/investor to the position it/they would have been in had the error not arisen.

The proposed framework differentiates on how an error should be appropriately rectified depending on the type of error concerned and four error types are defined under the framework as follows:

» an error in the calculation of the NAV (a **NAV Error**);

» an error relating to the investments of a fund and non-compliance with the applicable investment restrictions (an **Investment Breach Error**);

» an error related to the overpayment of a fee (a **Fee Error**) and

» errors which do not fall into the above three categories (a **Control Breach Error**).

The regulatory framework will apply to Fund Management Companies (which includes SMICs and internally managed AIFs) acting for Irish authorised UCITS or AIFs; and (ii) Irish Fund Management Companies (which may be acting for non-Irish authorised funds). Where an Irish Fund Management Company manages non-Irish authorised funds, the regulatory framework will apply without prejudice to requirements and guidance in any other relevant jurisdiction.

The consultation is open for feedback until **9 December 2019**.

BENCHMARK ADMINISTRATORS APPLICATION FORMS

On 29 March 2019, the Central Bank published a Key Facts Document outlining its information requirements in respect of applications for authorisation/registration as benchmarks administrators. The formal application forms are now available on the Central Bank's website together with application forms for recognition of third country benchmark administrators and endorsement of third country benchmarks.

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