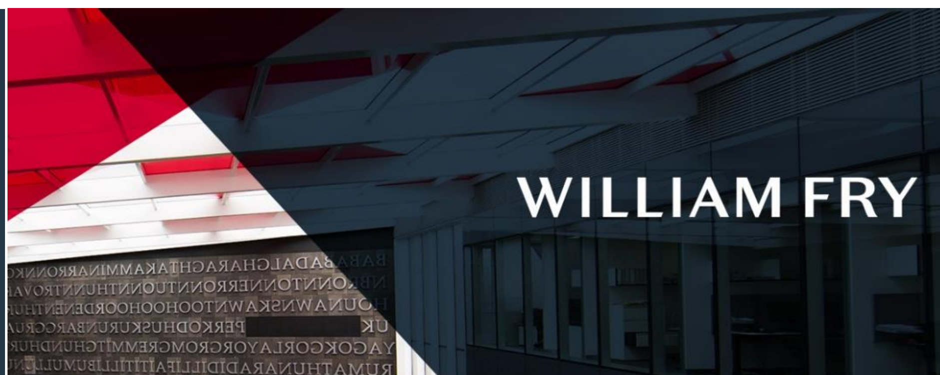
Asset Management & Investment Funds Update – July 2019



Central Bank outlines inspections timetable for asset management sector

On 19 June 2019, Lisa O'Mahony, Head of Advisory & Inspections Governance, Operational & Insurance Risk at the Central Bank of Ireland (**Central Bank**) delivered a presentation at the offices of William Fry in Dublin which included details of planned upcoming Central Bank themed inspections for the asset management industry.

2019/2020 themed inspections

In addition to the long-heralded CP86 compliance review now underway, the Central Bank has also indicated that it will be conducting a cross-sector thematic review on Fitness and Probity (**F&P**) compliance by banking and insurance firms (2019) and asset management firms (2020). The F&P review will follow on from the Central Bank's 'Dear CEO' letter dated 8 April 2019 and focus particularly on less significant institutions (i.e. those at the lower end of the PRISM rating spectrum), including entities authorised by the Central Bank last year. Areas of interest for the Central Bank as highlighted during the presentation on 19 June last were; (i) F&P procedures; (ii) initial and on-going due diligence; and (iii) engagement with the Central Bank.

The Central Bank also plans to conduct a thematic review on the subject of "best execution" within relevant MiFID authorised firms. This will be in addition to the MiFID II investment research review currently underway and the recently completed thematic review of fund service providers and MiFID II firms to evaluate the approaches in use of compliance, risk and internal audit services. In relation to the latter, the Central Bank advised, in a speech to industry on 13 June 2019, that it envisages issuing an industry letter in the coming months outlining what actions need to be taken, if any, considering issues highlighted during its thematic review.

Upcoming consultation on framework for investment fund errors

On 13 June 2019, the Director of Asset Management and Investment Banking of the Central Bank advised stakeholders of the Central Bank's intention to consult industry on the area of investment fund errors. The Director confirmed that this is with a view to the Central Bank issuing guidance and related requirements in this area "in order to ensure that Irish authorised funds and their service providers are actively identifying any errors in the valuation and pricing of funds and dealing with these in an appropriate manner". While acknowledging the existence of the Irish Funds guidance for industry in this area, the Director noted that "the consultation paper will seek to set out a consistent and transparent approach for industry, highlighting best practice and promoting investor protection. It is the intention of the Central Bank to establish a clear regulatory framework for errors which will outline our expectations in terms of what should happen when an error occurs, for example, what communication or disclosure should be undertaken and when it may be appropriate to pay compensation to affected parties."

The Director did not provide a timeline for the consultative process or the subsequent publication of regulatory guidance however, the consultation is anticipated by industry to issue in Q3/4 2019.

Copyright © William Fry 2019. All Rights Reserved in Association with Tughans, Northern Ireland www.williamfry.com
This publication is intended only as a general guide and not as a detailed legal analysis. It should not be used as a substitute for professional advice based on the facts of a particular case.

New Central Bank UCITS Regulations 2019 published

On 31 May 2019, the Central Bank of Ireland (the **Central Bank**) amended and consolidated its Central Bank UCITS Regulations with the publication of the Central Bank UCITS Regulations 2019 (the **2019 Regulations**). Simultaneously, the Central Bank published a feedback statement to the consultative process, CP119, which preceded the publication of the 2019 Regulations, and which provides feedback from the Central Bank to the responses received to CP119. On 6 June 2019, the Central Bank issued a revised version of its UCITS Q&A document which it updated to include new Q&As on the application of the 2019 Regulations.

Changes to the Irish UCITS regime introduced by 2019 Regulations

Along with a general update and consolidation of the Central Bank UCITS Regulations 2015, 2016 and 2017, the publication of the 2019 Regulations introduced a limited number of new and amended rules. In addition, the 2019 Regulations codify existing regulatory guidance on the establishment of share classes and the calculation and payment of performance fees. As a result of this codification, previous guidance in these areas has now been placed on a statutory footing thus making it enforceable by the Central Bank in accordance with its enforcement/sanctions regime.

Share Classes

On 30 January 2017, ESMA issued an Opinion entitled 'Share classes of UCITS' which set out high-level principles to be adhered to when setting up different share classes. The Central Bank implemented the terms of ESMA's Opinion by updating its regulatory guidance note entitled 'UCITS and AIF Share Classes'. The Central Bank has now placed these updates to its guidance note on a statutory footing through the publication of the 2019 Regulations and, specifically, by amending Regulation 26 of the Central Bank UCITS Regulations 2015.

Regulation 26 of the 2019 Regulations includes new paragraphs (g) – (l) which set out requirements, broadly similar to those in the regulatory guidance note, on (i) stress testing at share class level; (ii) charging of administrative costs; (iii) attribution of risk and costs of hedging; (iv) cover for future obligations; and (v) derivative and counterparty exposure limits.

Schedule 7(22) and Schedule 8(15) of the 2019 Regulations introduce a new requirement to include in the Annual Report and Half-Yearly Report, respectively and where applicable, "an up-to-date list of all share classes of the UCITS in issue during the reporting period and identifying whether the relevant share class is hedged."

Performance Fees

In addition to the codification of pre-existing provisions in the Central Bank's Guidance Note 'UCITS Performance Fees' under Regulation 40 of the 2019 Regulations, Regulation 40(4) incorporates a new requirement for performance fees to be calculated and payable no more than once a year. The application of this new requirement is subject to a transitional period of 18 months for UCITS in existence on 31 May 2019. The Central Bank, through the publication of two new Q&As in its UCITS Q&A document, provides clarificatory guidance on the application of this new requirement. Q&A 1091 states that, notwithstanding the new requirement, the crystallisation and payment of a performance fee upon redemption will continue to be permitted as it is not considered an annual calculation for the purposes of the new Regulation 40(4). Central Bank Q&A 1090 clarifies that it is acceptable to charge performance fees at (i) an individual investor level or (ii) at a share class/fund level, as adjusted for subscriptions and redemptions.

Financial Accounts

The 2019 Regulations replace the requirement for UCITS management companies to prepare, and file with the Central Bank within two months of the period, accounts covering the second half of the financial year with a requirement to file within one month, accounts covering the full 12 months of the financial year. This is in addition to the existing requirement to prepare and file half-yearly accounts, covering the first six months of the financial year, within two of the months of the period in question.

The 2019 Regulations also clarify and amend the pre-existing requirement for the first set of annual audited accounts of a UCITS to be produced, and filed with the Central Bank, within 18 months of incorporation/establishment. Under Regulation 81(2), the first set of annual audited accounts must still be prepared within 18 months of incorporation/establishment however, it has been clarified that such accounts are to include those sub-funds launched within the relevant period. The filing requirement for the annual audited accounts has been amended to provide that the accounts must be filed with the Central Bank within four months of preparation and in any event no later than 4 months after the expiration of the 18-month period for preparation. Previously, the preparation and filing of accounts was required within the 18-month period post establishment/incorporation. In its feedback statement to CP119, the Central Bank notes that it will consider waiver requests from this requirement, on a case-by-case basis, should a waiver be justified by the particular circumstances outlined in the request.

Treatment of cash held as ancillary liquid asset

Regulation 7 of the 2019 Regulations and a new Central Bank Q&A 1092 clarify that the requirements for deposits i.e. the types of credit institutions with whom they may be held[1] and the exposure limits[2] in the UCITS Regulations, are to be applied equally to cash held for ancillary liquidity purposes.

[1] (a) a credit institution authorised in the EEA; (b) a credit institution authorised within a signatory state, other than a Member State of the EEA, to the Basle Capital Convergence Agreement of July 1988; (c) a credit institution in a third country deemed equivalent pursuant to Article 107(4) of the Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

[2] (b) A UCITS shall not invest more than 20% of its assets in deposits made with the same body.

Copyright © William Fry 2018. All Rights Reserved in Association with Tughans, Northern Ireland www.williamfry.com
This publication is intended only as a general guide and not as a detailed legal analysis. It should not be used as a substitute for professional advice based on the facts of a particular case.

Suspension notifications

The regulatory suspension notification requirements have been clarified to provide that the Central Bank must be notified upon the lifting of any suspension or, if the suspension has not been lifted within 21 days of its application, the Central Bank must be provided with an update at that point and at each subsequent period of 21 working days until the suspension is lifted.

Money Market Fund Regulation (**MMFR**)

The 2019 Regulations incorporate amendments necessary to take account of the coming into force of the MMFR on 20 July 2017. These amendments consist principally of the disapplication of certain provisions to avoid duplication with the MMFR and the update of legislative references.

Timeline is fixed for introduction of Cross-Border Fund Distribution measures

On 14 June 2019, the package of legislative measures designed to reduce barriers to the cross-border distribution of funds (the **CBDF Legislation**) was adopted by the Council of the EU and will be signed into law on 20 June 2019. Once signed, the CBDF Legislation will be published in the Official Journal and come into force 20 days following its publication. Entry into force is expected to take place in the course of August 2019.

Key measures

The CBDF Legislation, adopted in the form proposed by Parliament on 16 April 2019, incorporates a Directive amending the cross-border marketing provisions of both the UCITS Directive and AIFMD and a Regulation setting down additional requirements, most significantly in respect of disclosures to be included in marketing communications by AIFMs and UCITS management companies.

Key new measures under the CBDF Legislation include: (i) the introduction of an ability for EU AIFMs to undertake "pre-marketing" (as defined) of established (not yet marketed) or not yet established AIFs in the EU; (ii) the introduction of an ability for EU AIFMs and UCITS managers, who wish to discontinue marketing in a Member State, to withdraw notifications made to that Member State; (iii) codification of an EU level framework for EU AIFMs marketing AIFs to retail investors; (iv) removal of the requirement for UCITS managers to maintain a physical presence in the host Member State in which a UCITS is registered to market (EU AIFMs will also benefit from this under the new framework for marketing to retail investors); and (v) the imposition of EU level disclosure requirements for UCITS and AIF marketing communications.

The CBDF Legislation also formalises the decision to extend, until 31 December 2021, the exemption from the requirement for UCITS to produce a key information document under the Packaged Retail Investor Information Product (**PRIIPs**) legislation.

Transitional arrangements

The new measures referred to at (i) – (v) above will apply from 24 months after the publication and entry into force of the CBDF Legislation, which is expected in August 2019 .

Market makers permitted to short sovereign debt to hedge long corporate bond positions

Regulation 236/2012 on short selling and certain aspects of credit default swaps (the **SSR**) came into full effect on 1 November 2012. It was introduced to address, at an EU level, systemic issues with short selling and certain credit default swaps while also recognising the important role short selling plays in ensuring the proper functioning of financial markets. The core objective of the SSR is to prevent the disorderly decline in the price of a financial instrument which may give rise to serious investor protection concerns.

In April 2013, ESMA issued guidelines detailing the exemption for market making activities and primary market operations from requirements of the SSR (the **ESMA Guidelines**). The ESMA Guidelines set down the conditions to be met to qualify for the exemption under the SSR, including a requirement for market makers:

- to be a member of the trading venue on which it is dealing in the financial instrument for which it notifies the exemption; and
- to deal in shares (or the prescribed instruments listed) of an issuer in scope of the regime or a sovereign issuer (in the prescribed instruments as listed) as defined under the regime.

On 6 June 2019, the Central Bank of Ireland (the **Central Bank**) advised that it considered there to be a lack of convergence across Member States in the application of the ESMA Guidelines and that a significant number of National Competent Authorities do not apply the ESMA Guidelines in full. The Central Bank confirms that, until the lack of convergence is remedied, it will not apply the above provisions of the ESMA Guidelines to market makers seeking the exemption under the SSR. "The decision of the Central Bank means that firms that wish to avail of the exemption …. for market making activities …. may do so in respect of sovereign debt to hedge positions in corporate bonds, provided there is a correlation between the two. For these purposes the correlation requirement for the hedging to qualify for the exemption is limited to the benchmark sovereign [bond] that the corporate bond is priced and/or actively traded against. Evidence of this correlation must be presented to the Central Bank upon notification of an intention to avail of the exemption."

Copyright © William Fry 2018. All Rights Reserved in Association with Tughans, Northern Ireland www.williamfry.com
This publication is intended only as a general guide and not as a detailed legal analysis. It should not be used as a substitute for professional advice based on the facts of a particular case.

Central Bank updates its Brexit FAQ for Firms

On 10 June 2019, the following FAQ was added to the Central Bank's published Brexit FAQ for firms:

"Can an Irish authorised firm second staff from the UK to do business that was formerly done by a UK authorised entity?

The Central Bank recognises that secondment can be a useful business solution for staffing of certain functions, especially in the early and growth stages of a business. Where secondments are used on a long term basis, the Central Bank will expect that the secondees are close to the business of the Irish firm and do not present a conflict of interest. Applications for the use of secondees will be considered by the Central Bank on a case by case basis. The Central Bank will consider, among other things, the time being dedicated to the operations of the Irish firm and availability of sufficient local management resources to oversee the seconded employees. The Central Bank will also consider the extent to which the interests of the secondees are aligned with the Irish firm or are in reality aligned with another economic or legal entity."

ESMA issues new Q&As for depositaries of UCITS and AIFs

On 4 June 2019, ESMA updated both its UCITS and AIFMD Q&A documents to include five new Q&As in each in relation to the performance and delegation by the depositary of its statutory duties.

In brief, the UCITS and AIFMD Q&As provide the following guidance for depositaries of UCITS and AIFs:

- delegation of safekeeping is subject to subject to the [UCITS/AIFM] Directive requirements;
- delegation of cash flow and oversight functions is not permitted;
- delegation of supporting tasks, such as administrative or technical functions, that are linked to cash flow and oversight functions may be delegated to third parties where all of the following conditions are met:
  - the execution of the tasks does not involve any discretionary judgement or interpretation by the third party in relation to the depositary functions;
  - the execution of the tasks does not require specific expertise in regard to the depositary function; and
  - the tasks are standardised and pre-defined.
- a delegate, where it has the ability to transfer fund assets, must be appointed in accordance with the [UCITS/AIFM] Directive requirements on delegation of safekeeping of assets;
- if a depositary is part of a group any internal allocation of functions to its head office in another Member State shall not circumvent the requirement for the depositary to be established in the Member State of the fund. The depositary must have the operational infrastructure and internal governance system adequate to carry out its functions autonomously from its head office;
- delegation of functions to a group entity is considered delegation to a third party and subject to the Directive requirements on delegation.

EMIR Refit – FCs permitted to use netting in clearing threshold calculation

On 14 June 2019, ESMA updated its EMIR Q&A document to include two new Q&As on the implementation of the EMIR Refit Regulation, amending EMIR with respect to clearing and reporting obligations on derivative counterparties (the **EMIR Refit**). The first relates to the EMIR intragroup reporting exemption and the second provides guidance on the calculations for determining whether a fund's OTC derivative holdings are above or below the clearing thresholds.

Q&A on clearing threshold calculations

The clearing obligation for small or category 3 FCs set down by EMIR Refit is based largely on that already in place for NFCs. There are, however, a few key differences between FC and NFC obligations. One such difference is the obligation on a FC, who elects to undertake clearing threshold calculations, to include **all** OTC derivatives it (or, to the extent it is a part of a group, its group) enters into, in the calculation of its month-end average derivative positions (EMIR Refit Article 4a(3)). NFCs are however, permitted to exclude OTCs which are 'objectively measurable as reducing risks' i.e. in-scope hedging transactions.

ESMA also permits NFCs, via a Q&A issued to interpret a recital under EMIR, to net positions when calculating whether they are above or below the clearing thresholds.

The ESMA Q&A issued on 14 June last updates this Q&A and applies the ability to net positions in the clearing threshold calculation to both NFCs and FCs.

Copyright © William Fry 2018. All Rights Reserved in Association with Tughans, Northern Ireland www.williamfry.com
This publication is intended only as a general guide and not as a detailed legal analysis. It should not be used as a substitute for professional advice based on the facts of a particular case.

It should be noted that the level of netting permitted in this context may be narrower than that permitted under current fund rules. For example, AIFMD rules for calculating exposure under the commitment method allows netting of contracts with the same counterparty but with different maturities subject to the duration netting rules however, EMIR netting only permits full or partial offsetting of contracts having exactly the same characteristics with the only exception being the direction of the trade and the notional amount (in the case of partial offset concluded with the same counterparty).

The following is extracted from ESMA's Q&A OTC Question 3 on EMIR outlining the relevant netting provision for FCs:
"(f) In order to determine whether it is above or below the clearing thresholds, the counterparty should first net their positions per counterparty, including where the counterparty is a CCP, and contracts and then add up the absolute notional value of all these net positions (calculated based on the notional amounts of the contracts). Netting per contracts and counterparty should be understood as fully or partially offsetting contracts having exactly the same characteristics (type, underlying, maturity, etc.) with the only exception being the direction of the trade and notional amount (in case of partial offset) concluded with the same counterparty."

The same Q&A (OTC Question 3) also provides clarification on the 12-month period that may be used by FCs for the performance of clearing threshold calculations:
"(g) It could be challenging for a counterparty performing calculations a few days after the end of the previous month to calculate and use the month-end position of that month. For that reason, the counterparty could calculate with the 12-month period that started a month earlier and ended with the previous month- end. E.g. if a counterparty is performing calculations on 1 November 2019 and encounters difficulties with calculating its positions using the figures from 1 November 2018 to 31 October 2019, it can use a 12-month period ending on the previous month: from 1 October 2018 to 30 September 2019."

ESMA consults on SFTR Reporting Guidelines

On 15 July 2019, ESMA will host an Open Hearing at its premises in Paris on the consultation paper it published on 23 May 2019 entitled 'Guidelines for reporting under Articles 4 and 12 SFTR' (the **Guidelines**) (the **SFTR Consultation**). The SFTR consultation will remain open until 29 July 2019 and ESMA will consider the feedback it receives to the SFTR consultation in Q3 2019 with ESMA's final report on the Guidelines on Reporting under SFTR expected to issue in Q4 2019.

The SFTR Consultation consists of nine separate sections and runs to a substantial 179 pages. The key sections for reporting counterparties are likely sections 5 (principles) and 6 (data fields), with sections 7 and 8 dealing with TR feedback and section 9 specifying particular instances related to authorities' access to data.

The purpose of the Guidelines, as set out in section 3 of the SFTR Consultation, is to provide clarity and a harmonised implementation on the following aspects of the SFTR:

a) the number of reportable SFTs;
b) the population of reporting fields for different types of SFTs;
c) the approach used to link SFT collateral with SFT loans;
d) the population of reporting fields for margin data;
e) the population of reporting fields for reuse, reinvestment and funding sources data;
f) the management by counterparties of feedback from TRs, namely in the case of rejection (i) of reported data and (ii) of reconciliation breaks; and
g) the provision of access to data to authorities by TRs.

The SFTR obliges mandatory delegation of reporting by UCITS to its UCITS management company and by AIFs to its appointed AIFM. As previously reported, the commencement date for reporting by UCITS management companies and AIFMs of SFTs was fixed in March 2019. UCITS management companies and AIFMS will be required to commence reporting of in scope SFTs from 11 October 2020.

Publication of draft legislation to amend Investment Limited Partnership Act 1994

On 20 June 2019, the Investment Limited Partnerships (Amendment) Bill 2019 (the **ILP Bill**) was published. The ILP Bill proposes a series of amendments to the Investment Limited Partnership Act 1994 (the **ILP Act**), as well as limited amendments to the Irish Collective Asset management Vehicle Act 2015 (the **ICAV Act**). For some time now, industry have been lobbying for legislative amendments to the ILP Act which would address the reasons underlying the limited uptake of the ILP as a fund vehicle since its introduction in 1994. The ILP Bill will now proceed through the legislative process before it is enacted as law.

The current draft of the ILP Bill proposes amendments to the ILP Act, including;

- to permit the establishment of umbrella funds;
- to permit a limited partner to participate on boards and committees which will be deemed not to be taking part in the conduct of the business and so does not result in loss of liability for a limited partner;

Copyright © William Fry 2018. All Rights Reserved in Association with Tughans, Northern Ireland

This publication is intended only as a general guide and not as a detailed legal analysis. It should not be used as a substitute for professional advice based on the facts of a particular case.

- to allow the use of an alternative foreign name in the case of foreign Investment Limited Partnerships;
- to revise the requirements for amending a partnership agreement;
- to create a statutory transfer of assets and liabilities on the admission or replacement of a general partner (all rights or property of the ILP shall vest in the incoming partner or existing general partners) or the withdrawal of a general partner (all rights or property of the ILP shall vest in the remaining partner or existing partners); and
- to ensure that limited partners who do not take any part in the conduct of the business of the partnership cannot be prosecuted for any offences committed in the management of the partnership.

The ILP Bill also amends the ICAV Act. The amendments are principally clarificatory, typographical corrections or made to align certain provisions of the ICAV Act with their counterparts under the Companies Act 2014. Helpfully, the ILP Bill addresses the inconsistency between the statutory sole object of an ICAV and that of a UCITS by amending the sole object of an ICAV authorised as a UCITS to refer to that of a UCITS as set out in the UCITS Regulations transposing the UCITS Directive into Irish law.

While no doubt a welcome development, there is still significant work to do before the ILP Bill is enacted into law. Clients should be aware of the potential for an extended timeline to entry into force, not least due to the need for all parties involved in the process to dedicate resources to preparing for Brexit, and the likelihood of amendments to the current draft of the ILP Bill during this process.

JP Morgan fined €1.6m by the Central Bank for regulatory breaches relating to outsourcing activities

On 24 June 2019, the Central Bank reprimanded and fined J.P. Morgan Administration Services (Ireland) Limited (**JPMAS**) €1,600,000 for regulatory breaches relating to the outsourcing of fund administration activities.

JPMAS admitted to three breaches of the Outsourcing Requirements contained in Annex II of Chapter 5 of the AIF Rulebook (the Outsourcing Requirements) and one breach of the Prudential Handbook for Investment Firms 2008 (the Handbook).

The Central Bank determined that the appropriate fine was €2,286,000, which was reduced by 30% in accordance with the settlement discount scheme provided for in the Central Bank's Administrative Sanctions Procedure.

The Central Bank's investigation identified serious failings in the JPMAS outsourcing framework including:

1. Failure to obtain the prior approval of the Central Bank to outsource fund administration activities.
2. Failure to have adequate control systems to ensure that the Firm satisfied the Central Bank's outsourcing requirements for fund administrators.

As a result of these failings, the Central Bank found that JMPAS did not always have a clear understanding of, and controls around, its outsourcing arrangements. This undermined the ability of JPMAS to effectively identify and manage the risks associated with its outsourcing arrangements. In addition, the Firm's failings undermined the Central Bank's ability to properly assess, monitor and supervise JPMAS's outsourcing of regulated activities.

JPMAS persistently failed to remediate the root causes of these failings despite repeated supervisory intervention by the Central Bank over a number of years. This was clearly an aggravating factor in this case.

The Central Bank's Director of Enforcement and Anti-Money Laundering, Seána Cunningham, said:

"Outsourcing plays a key role in the provision of regulated financial services and it is vital that regulated firms can demonstrate a clear understanding of their outsourcing arrangements, the associated risks and the effectiveness of the governance and risk management measures in place in respect of those arrangements. This is the first enforcement action taken by the Central Bank against a fund administration firm in relation to outsourcing failures.

When firms outsource activities, they do not outsource their responsibilities. It is important for firms to have strong controls in place around the governance and oversight of all outsourcing arrangements to ensure that they comply with all legal and regulatory requirements. The requirement for fund administrators to seek the approval of the Central Bank prior to outsourcing fund administration activities is a core regulatory requirement. Compliance with this requirement ensures that the Central Bank is in a position to effectively assess, monitor and supervise the outsourcing of regulated activities.

JPMAS's failures in this case demonstrated unacceptable weaknesses in its outsourcing framework. These weaknesses were further evidenced by the Firm's repeated failures to satisfactorily remediate the issues identified by the Central Bank as part of its supervisory engagement with the Firm. The fine imposed reflects JPMAS's failure to address the root causes of these weaknesses over several years."

Outsourcing is, and will continue to be, an area of particular focus for the Central Bank. This enforcement action reflects the importance the Central Bank places on firms' compliance with their legal and regulatory obligations where they seek to outsource regulated activities.

Copyright © William Fry 2018. All Rights Reserved in Association with Tughans, Northern Ireland www.williamfry.com
This publication is intended only as a general guide and not as a detailed legal analysis. It should not be used as a substitute for professional advice based on the facts of a particular case.