WILLIAM FRY

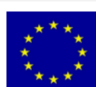
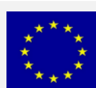
// ASSET MANAGEMENT & INVESTMENT FUNDS

Asset Management & Investment Funds Update

December 2021

Key Dates & Deadlines: Q4 '21 / Q1 '22

Date		Details
14 December 2021		Central Bank deadline for filing offering document updates addressing the SFDR Taxonomy-related disclosure rules effective 1 January 2022. For further details see this month's briefing on topic.
17 December 2021		Transposition deadline for EU Whistleblowing Directive. Draft legislation providing for the transposition of the Directive, in the form of amendments to the Protected Disclosures Act 2014, is proceeding through the Irish legislative process. For further details on the Directive see our July 2021 briefing Winds of Change are Blowing – Significant Extension to Protections for Whistleblowers in Ireland.
31 December 2021		Current end date of PRIIPs exemption for UCITS although an extension to 31 December 2022 is imminent. For further details see this month's article on topic.
31 December 2021		Expiration date for interim company law flexibility measures introduced under the Companies (Miscellaneous Provisions) (COVID-19) Act. It is anticipated that the year-end expiration date will be extended however, a formal announcement has yet to be made. For further details see our August 2020 briefing COVID-19 Company Law Changes.
31 December 2021		LIBOR cessation date. On 5 March 2021, the UK FCA announced that all of the 35 LIBOR benchmarks settings will cease to be provided by any administrator or will no longer be representative (i) immediately after 31 December 2021, in the case of all GBP, EUR, CHF and JPY settings, and the 1-week and 2-month USD settings; and (ii) immediately after 30 June 2023, in the case of the remaining USD settings. For further details see our August 2020 briefing EU Solution to LIBOR Cessation & Non-EU FX Spot Rate Access.
31 December 2021		Central Bank completion deadline for review of fund liquidity risk management frameworks (**LRMF**) by UCITS managers. For further details see our April 2021 briefing Intense Regulatory Focus on Liquidity Risk Management Continues and the Central Bank's follow-up industry correspondence of 18 May 2021.

31 December 2021		Deadline for unit trusts and ICAVs, in existence on 1 July 2021, to file PPS details of their beneficial owners on the Central Bank's register of beneficial ownership information. On 18 November 2021, the Central Bank confirmed that it will not be in a position to collect PPS details until 2022. Central Bank guidance on this issue is to be published, however for beneficial owners who do not hold a PPSN, an identity verification process is proposed which will allow for the submission of a declaration in place of PPS details.
31 December 2021		Deadline for ICAVs, unit trusts, ILPs and CCFs to resubmit beneficial ownership details to the Central Bank using an updated beneficial ownership filing template reflecting additional information required by the Central Bank. On 18 November 2021, the Central Bank confirmed that the new filing template will be available for use from 3 December 2021 and resubmissions using the revised template should be made via the ONR before 17 December 2021.
1 January 2022		SFDR periodic report and Taxonomy-related disclosure rules in effect. For further details see this month's article on topic.
3 February 2022		ESMA Guidelines on Marketing Communications in effect. For further details see our June 2021 briefing 'New Disclosure Rules for UCITS and AIF Marketing Materials'.

AIFMD Review Legislation Published: did ESMA get what it asked for?

On 25 November 2021, the European Commission published a package of CMU-related legislative measures, including proposed revisions to the AIFMD and UCITS regimes (the **Proposal**) focussing on:

- harmonisation of the UCITS and AIFMD regimes;
- permitted activities of AIFMs and UCITS managers (fund management companies or **FMCs**);
- FMC substance and delegation rules;
- fund liquidity risk management;
- loan-originating AIFs;
- depositaries; and
- FMC supervisory reporting.

As discussed here, the Proposal was preceded by a wide-ranging and detailed set of recommendations for AIFMD and UCITS regime amendments from ESMA. The following analysis highlights the Proposal's key impacts for FMCs and the extent to which it addresses ESMA's August 2020 recommendations.

ESMA RECOMMENDATION	PROPOSED AIFMD / UCITS AMENDMENT	COMMENT
UCITS/AIFMD HARMONISATION		
Harmonise AIFMD and UCITS' reporting and delegation rules.	*UCITS Delegation* The Proposal provides for the adoption of UCITS delegated measures which will, in 'large part', apply AIFMD delegation rules to UCITS managers. *UCITS Reporting* The Proposal provides for the adoption of UCITS delegated measures	The Proposal provides for the implementation of ESMA's recommendations and notes that the UCITS regime "*should ensure for the management companies of UCITS comparable conditions where there is no reason for maintaining regulatory differences for UCITS AIFMs [concerning the]*

Copyright © William Fry 2021. All Rights Reserved

ESMA RECOMMENDATION	PROPOSED AIFMD / UCITS AMENDMENT	COMMENT
	specifying the extent and form of periodic supervisory reporting by UCITS managers on markets and instruments in which they trade on behalf of UCITS. *AIFM Investor disclosures* The Proposal expands AIFMD investor disclosure rules providing for additional disclosures on fees borne by the AIFM or its affiliates and periodical reporting on all direct and indirect fees and charges that were directly or indirectly charged or allocated to the AIF or to any of its investments.	*delegation regime, regulatory treatment of custodians, supervisory reporting requirements and the availability and use of LMTs."* Notably, the Proposal also provides for, potentially onerous. additional AIFMD investor disclosures *"to allow an AIF's investors to better track the investment fund's expenses."*
FMC ANCILLARY SERVICES		
Clarify scope of FMC permitted activities in addition to collective portfolio management.	The list of AIFMD-permitted ancillary services (Article 6(4)) is extended to include administration of benchmarks or credit servicing.	The extended list of permitted activities is (without explanation) not applied in respect of UCITS managers.
Clarify rules applicable to FMCs performing ancillary services.	AIFMs providing ancillary services involving MiFID financial instruments are subject to MiFID rules and, with regard to other assets which are not financial instruments, AIFMs are subject to AIFMD.	This clarification is included in recital (4) of the Proposal but no legislative amendments supporting the clarification are included nor are there comparable clarifications to the rules applicable to UCITS managers' provision of ancillary services. Both the AIFMD and UCITS Directive already apply specific provisions of the MiFID regime to AIFMs and UCITS mangers performing MiFID services in respect of financial instruments and so perhaps the recital clarification can be inferred from existing rules.
DELEGATION & SUBSTANCE		
Clarify rules applicable to FMC delegates providing investment management for an AIF/UCITS and consider whether additional rules for third country delegates are necessary to avoid circumvention of AIFMD/UCITS regulatory standards.	The Proposal requires FMCs to notify ESMA of arrangements under which more risk or portfolio management is delegated outside the EU than is retained by AIFMs or UCITS managers. The content, forms and procedures for ESMA delegation notifications will be set out in delegated measures based on regulatory technical standards to be drafted by ESMA. The delegation information is to allow ESMA make use of already available powers, such as conducting peer reviews of supervisory practices in	The response to ESMA's request is likely to be welcomed by industry as, although amendments to the delegation rules are not off the table, the Proposal postpones consideration of any such measures until adequate data on the extent and impact of third-country delegation is to hand.

Copyright © William Fry 2021. All Rights Reserved

ESMA RECOMMENDATION	PROPOSED AIFMD / UCITS AMENDMENT	COMMENT
	applying rules on delegation with a particular focus on preventing the creation of letter-box entities as well as to support the Commission's future review of the UCITS and AIFMD delegation regimes. Third-country entities with access to the internal market, including non-EU AIFs and non-EUAIFMs, must not be located in a third country identified as high risk by the EU or that is deemed un-cooperative in tax matters.	
Clarify the maximum extent of delegation permitted and consider quantitative clarification of the letter-box rule (i.e., FMC may be a letter box entity where it delegates performance of portfolio and/or risk management functions to an extent that exceeds by a substantial margin the investment functions performed by the FMC).	The proposal contains substance-related amendments to both the UCITS and AIFMD regimes, including: • clarifications that FMCs must have, and evidence on authorisation, appropriate technical and human resources to carry out their functions and to supervise delegates • FMCs must employ at least two persons full-time or engage two persons, who are not employed by the FMC but nevertheless are committed to conduct that FMC's business on a full-time basis and who are resident in the EU • AIFMD delegation rules (principally set out in AIFMD Level 2) are to be applied, in 'large part' to UCITS managers and principally through the future adoption of UCITS delegated measures. However, the proposal amends the UCITS regime to require UCITS managers to justify their entire delegation structure based on objective reasons (as is required under AIFMD Level 1).	While the inclusion of substance-related amendments was to be expected, it is helpful that the Proposal specifically recognises the benefits of delegation and instead of (further) limiting the extent of delegation permitted under the regimes, opts to provide *"necessary clarifications while preserving the benefits of the delegation regimes under the AIFMD and UCITS [Directive]".*
Address legal uncertainties as to the scope of delegation rules, including whether the provision of 'supporting tasks' is subject to delegation rules, and ensure a level-playing field between AIFMD/UCITS and MiFID.	The Proposal clarifies that UCITS and AIFMD delegation rules apply, respectively, to all functions listed in Annex II of the UCITS Directive and Annex I AIFMD as well as to the delegation of ancillary (additional to collective portfolio management) services permitted under Article 6(3) of the UCITS Directive and Article 6(4) AIFMD.	While ESMA's recommendations referenced the AIFMD recital which limits the application of the delegation rules to portfolio and risk management functions and indeed appeared to apprehend the requirements as not applying to other functions listed in Annex 1 (administration, marketing and activities related to fund assets), the Proposal aims to address the legal uncertainties raised by applying FMC delegation rules, not only to all the functions listed

Copyright © William Fry 2021. All Rights Reserved

ESMA RECOMMENDATION	PROPOSED AIFMD / UCITS AMENDMENT	COMMENT
		in Annex 1 AIFMD/Annex II UCITS but also to any permitted ancillary services e.g. which may be carried out under a FMC MiFID top-up licence.
Clarify rules for secondment arrangements and how these align with substance and delegation rules.	Not addressed in the Proposal.	
Consider measures to address issues related to white-label/third-party service providers.	Not addressed in the Proposal.	
	LIQUIDITY RISK MANAGEMENT	
Include ESRB-recommended liquidity risk management tools (**LMTs**).	The Proposal provides for a minimum harmonised set of available LMTs of (i) suspension; (ii) redemption gates; (iii) redemption notice periods; (iv) redemption fees; (v) swing pricing; (vi) anti-dilution levies; (vii) redemptions in kind; and (viii) side pockets. FMCs must: • in addition to suspension, choose at least one other LMT; • notify the competent authority on activating or deactivating a LMT; • inform investors of the conditions for the use of LMTs The Central Bank will have the power to require FMCs (including non-EU AIFMs) to activate or deactivate a relevant LMT in accordance with delegated measures to be adopted based on ESMA regulatory technical standards.	The Proposal is in line with the increased regulatory focus on liquidity risk management and the direction of travel in this space is notable, in particular for FMCs currently reviewing liquidity risk management frameworks in advance of the Central Bank's year-end deadline for such reviews.
	LOAN-ORIGINATION	
Consider adoption of a specific framework for loan origination within the AIFMD.	The Proposal contains minimum harmonisation principles for AIFMs active in credit markets, including for the: • implementation of effective policies, procedures and processes for the granting of loans; • restriction of lending (not to exceed 20% of AIF's capital) to a single borrower, when this borrower is a financial institution; • prohibition of AIF lending to its AIFM its staff, its depositary or its delegate;	The Proposal considers that loan-originating funds can provide an alternative source of financing and the minimum harmonisation of national regimes for loan-originating AIFs in line with the general principles, which are aligned with the diversification thresholds applicable to retail-investor ELTIFs, will therefore support the CMU strategy. While largely in line with Central Bank rules for loan-QIAIFs, it remains to be seen whether the Proposal will, in final form, impact national rules.

Copyright © William Fry 2021. All Rights Reserved

ESMA RECOMMENDATION	PROPOSED AIFMD / UCITS AMENDMENT	COMMENT
	• retention of an economic interest of 5% of the notional value of the loans they have granted and sold off; • establishment of AIFs engaged in loan origination to a significant extent as closed-ended structures; • legitimisation of lending activity for AIFMs to allow AIFs extend loans across the EU.	
DEPOSITARY		
Assess the merit of a depositary passport.	The Proposal enables cross-border access to depositary services until the introduction of a depositary passport is feasible following further harmonisation of EU laws. The Proposal provides for the inclusion of CSDs (when providing custody services) in the custody chain but limits the due diligence requirements for European CSDs.	A depositary passport is not, according to the Proposal, currently feasible, however the ability to appoint a depositary other than in the home state of the AIF is intended to improve choice and enable a more competitive service-provider market.
SUPERVISORY REPORTING		
Various updates suggested to the AIFMD reporting regime.	The Proposal acknowledges that granularity of AIFMD reported data could be improved and provides for the simplification and streamlining of the current reporting obligations as part of future-adopted delegated measures replacing the current AIFMD supervisory reporting template.	The Proposal substantially postpones legislative changes to supervisory reporting under the UCITS and AIFMD regimes until after the outcome of an in-depth feasibly study by supervisors to explore potential synergies between existing reporting requirements under different EU laws.

Next Steps

The Proposal will now proceed through the EU legislative process and once finalised, Member States will have 24 months in which to transpose the adopted amendments to the UCITS and AIFMD regimes.

PRIIPs Exemption for UCITS Extended to December 2022

On 24 November 2021, EU legislators published their agreement to extend the PRIIPs exemption for UCITS to 31 December 2022. The extension, set out in so-called 'quick-fix' PRIIPs and UCITS legislation (to turn off UCITS KIID and turn on PRIIPs KID for UCITS), means that UCITS will now have until the end of 2022 to prepare and publish a PRIIPs KID in place of the UCITS KIID.

In addition to extending the UCITS exemption, the quick-fix legislation also addresses the issue, arising from the application of PRIIPs to UCITS, for UCITS sold only to professional investors. As discussed here, professional investor UCITS are not required to produce a PRIIPs KID but, following the application of PRIIPs rules to UCITS, remain subject to the requirement for all UCITS to produce a UCITS KIID.

The proposed legislative solution to this issue is to (i) specifically permit professional investor UCITS to produce either a UCITS KIID or a PRIIPs KID in satisfaction of UCITS KIID rules and (ii) preclude competent authorities

Copyright © William Fry 2021. All Rights Reserved

from imposing a requirement on professional investor UCITS to prepare a UCITS KIID if they choose to produce a PRIIPs KID.

While the proposed solution is to be welcomed, it does not address the wider issue of whether professional investors require any key information (be it a PRIIPs KID or UCITS KIID). However, the Parliament has requested the Commission's ongoing PRIIPs regime review to specifically include this issue and report on it as part of next year's PRIIPs reform proposals.

Next steps

The UCITS and PRIIPs quick-fix legislation must now be finalised and published by year-end to ensure implementation of the 12-month extension before the current PRIIPs exemption end-date of 31 December 2021. In addition, finalisation of the PRIIPs regime, which will be applicable to UCITS from December 2022, is expected in the coming weeks, once the amendments to the PRIIPs rules (principally to incorporate UCITS-specific provisions) are finalised (see here for further details).

Central Bank SFDR fast-track filing process for year-end deadline

On 17 November 2021, the Central Bank published notice of its intention (**Notice**) to operate a fast-track filing process for fund prospectus updates ahead of the upcoming SFDR deadlines of 1 January 2022 (SFDR Taxonomy-related disclosures) and the anticipated deadline of 1 July 2022 (SFDR Level 2 disclosures).

The fast-track process will operate in broadly similar terms to the Central Bank process in place ahead of the first SFDR deadline of 10 March 2021 deadline and requires:

- SFDR Taxonomy-related disclosures to be filed by COB on 14 December 2021 (subject to extension on an exceptional basis); and
- SFDR Level 2 filings to be filed between 31 March and COB on 27 May 2022 (subject to any amendments to the regime that may impact those dates e.g., further delays to the application date of SFDR Level 2).

As set out in the Notice, responsibility for compliance with SFDR rests with the relevant UCITS manager or AIFM which will be required to certify that the prospectus amendments filed using the fast-track process are (i) made in order to comply with requirements of the relevant legislation, (ii) that such amendments comply with the relevant legislation; and (iii) that no other changes have been made to the fund's prospectus.

Next Steps

Fund management companies should take note of the upcoming filing deadline of 14 December 2021 for prospectus updates necessary to comply with the SFDR Taxonomy-related disclosure rules (as discussed here). Notably, as discussed in this month's related briefing, the SFDR Level 2 application date has now been delayed to 1 January 2023. Further updates from the Central Bank on revised timelines for fast-track filing of SFDR Level 2 prospectus updates are, as such, awaited. Fund management companies should also note that the fast-track process for SFDR filings is not available for new fund/sub-fund applications or prospectus updates filed after relevant SFDR deadlines. Furthermore, while use of the fast-track process will result in noting/confirmation of prospectus updates filed, the Central Bank reserves the right to require revisions to such prospectuses in circumstances where queries arise following its intended sample review of fast-track submissions received.

Central Bank consults on macroprudential measures for property funds

On 25 November 2021, the Central Bank published a consultation paper on the introduction of measures designed to address financial stability concerns arising out of identified liquidity mismatch and excessive levels of leverage in property funds, including:

1. a 50% loan-to-value leverage limit for Central Bank-authorised qualifying investor alternative investment funds (**QIAIF**) investing over 50% directly or indirectly in Irish property assets (**Property Funds**). All loans, including affiliated and shareholder loans, would be included in the on-balance sheet leverage limit which would be applied by way of Central Bank notice under the Irish AIFM Regulations to Property Funds reporting leverage levels close to or above the 50% limit and, as such,

Copyright © William Fry 2021. All Rights Reserved

all Property Funds would, de facto, be subject to the limit. Existing Property Funds would have a three-year transition period from finalisation of the leverage limit to arrange for compliance; and

2. liquidity timeframe guidance for Property Funds, including an expected minimum 12-month period from redemption deadline to settlement date for Property Funds structured as open-ended with limited liquidity. The guidance would apply to new Property Funds from authorisation and existing Property Funds would be expected to make any necessary changes to take account of the guidance at the earliest opportunity.

Background

As previously highlighted (here), the Central Bank, along with other regulators, legislators and standards setters, has increasingly focussed on the necessity for a macroprudential framework for funds. Following its 2020 deep-dive survey of the Property Fund sector (**Deep Dive Survey**) (discussed here and below), the Central Bank identified financial stability issues arising out of the sector's elevated exposure to Irish property assets and financial vulnerabilities in the form of liquidity mismatches and high levels of fund leverage.

Liquidity Mismatch

The Central Bank considers liquidity mismatch in funds (i.e., where a fund's dealing frequency does not match the liquidity of the underlying assets) a potential source of financial vulnerability as it can force funds, in receipt of large redemption requests which may not be met out of liquid assets, to sell assets in a short period of time thus leading to dislocated prices and knock-on real economy effects.

Liquidity timeframes (i.e., time from redemption request deadline to redemption settlement date) of Property Funds ranges from 7 to over 1200 days, with 58% of funds (accounting for €13.6bn approx. of property assets) having timeframes of less than 200 days. Fund managers responding to the Deep Dive Survey estimated an average of 180-213 days to sell a property in normal economic times and 420 days in stressed economic times. The Central Bank is concerned, therefore, as to the *"significant liquidity mismatches in the majority of the funds surveyed"* estimating that, on the basis of the survey results, only 17% of property assets are held in funds which would avoid liquidity mismatches during stressed market conditions by having a liquidity timeframe of 400 days of more.

The Central Bank notes that liquidity mismatch risk in Property Funds can be mitigated by factors such as the level of liquid asset holdings (generally 5% of assets), infrequent dealing (most are closed-ended or limited liquidity funds) and a limited investor base (65% of property assets are held in single-investor funds). However, it remains concerned as to the surveyed funds' ability to deal with large redemption requests as the results highlight that the majority of Property Funds operate liquidity timeframes of less than 200 days. And while single-investor funds may not, due to the absence of first-mover advantage dynamics, be as susceptible to liquidity mismatch risks, the Central Bank is concerned as to the possibility of indirect liquidity mismatch risk given approximately one-fifth of such funds are financial institutions with multiple underlying investors.

Elevated levels of leverage

The Central Bank considers higher levels of leverage in Property Funds to be problematic as it can have an amplifying effect on decreasing equity returns in downward markets and, in its Deep Dive Survey results, pointed to several sources concluding that overall leverage has a negative impact on Property Fund returns.

The Deep Dive Survey found that a significant portion of funds (67% of single-investor and 41% of multi-investor) have leverage levels of more than 50%. While such levels are higher than the European average, the Central Bank acknowledges this is, in part, due to the significant presence of shareholder and affiliated lending in Irish Property Funds. However, even when affiliated loans are excluded from the leverage metrics, Irish Property Funds hold higher leverage than their European counterparts. And while most of the funds surveyed have a single investor, the Central Bank does not view this as necessarily affecting the increased vulnerability of being highly leveraged as a single investor may still look to sell fund assets, whether as result of being leveraged in its own right or otherwise, during stressed market conditions and thereby triggering downward price pressures.

The Central Bank has identified a cohort of Property Funds that have both liquidity mismatch and higher leverage. In total, 35 Property Funds, representing €5.2bn of property assets (or around 1.3 times the 2014-2019 average annual CRE investment transaction volume) both have liquidity timeframes of less than 180 days and have leverage greater than 50%. These funds are considered to be "*particularly vulnerable to an external shock or sudden economic downturn.*"

Copyright © William Fry 2021. All Rights Reserved

Next Steps

The consultation on the financial stability measures at 1 and 2 above is open until 18 February 2022 and the Central Bank requests that respondents provide reasons for responses given and that suggested changes are supported, where possible, by evidence which will support Central Bank consideration of issues raised. The Central Bank intends to provide feedback following the close of the consultation period but no timeframe for the feedback or publication of finalised measures has yet been indicated.

SFDR Level 2 Delayed to 31 December 2022

On 25 November 2021, the Commission wrote to its co-legislators confirming a further six-month delay to the application date of SFDR Level 2 from July 2022 until 1 January 2023. SFDR Level 2, to be based on ESA-adopted regulatory technical standards (**RTS**), will introduce detailed and prescriptive disclosure requirements for green funds in scope of SFDR Articles 8 and 9 and requirements for fund managers' disclosure of the principal adverse impact of investment decisions under SFDR (see here and here for further details).

In addition to confirming the delayed application of SFDR Level 2, the Commission's letter also addresses industry questions around proposed transitional arrangements for the publication of principal adverse impact (**PAI**) statements in accordance with SFDR manager-level rules for the disclosure of the PAI of investment decisions.

According to the ESA-adopted RTS (originally due to take effect on 1 January 2022) the first PAI statements, taking account of the quantitative assessment of PAIs using mandatory and optional PAI indicators appended to the RTS, were due for publication on 30 June 2023. Such statements are required to disclose on the quantitative assessment of PAIs, using the PAI indicators, on four separate calculation dates over the course of 2022. Given the delayed application of SFDR Level 2 (first until July 2022 and now until January 2023), industry had requested that the PAI disclosure rules be similarly delayed with the first PAI statement not becoming due before June 2024 (incorporating quantitative assessment of PAIs over the course of 2023).

However, the Commission's recent letter notes that the delayed application date of SFDR Level 2 is considered to negate the necessity for the PAI transitional arrangements set out in the ESA-adopted RTS and, as such, the first PAI statement using the PAI indicators will be required by 30 June 2023 referencing the quantitative assessment of PAIs in the period 1 January to 31 December 2022.

As a result, any fund managers' assessment of PAIs in compliance with SFDR must begin from 1 January next, a full 12 months before SFDR Level 2, including the mandatory and optional PAI indicators, is scheduled to take effect.

Next Steps

The finalisation and adoption by the Commission of the ESA-adopted RTS as SFDR Level 2 is expected in the coming weeks, however fund management companies may now adjust compliance planning to take account of the revised application date of 1 January 2023. Fund management companies should note however, that the delayed application of SFDR Level 2 will not impact the 1 January 2022 deadline:

- for fund management companies opting to disclose PAIs, to begin assessing PAIs using the PAI indicators set out in the ESA-adopted RTS (see here for further details).
- for compliance with SFDR Taxonomy-related prospectus and annual report disclosures (see here for further details).
- for compliance with the SFDR annual report disclosures for funds in scope of SFDR Article 8 and Article 9 (see here for further details).

IOSCO recommendations for users of ESG ratings and data products

On 23 November 2021, IOSCO published a set of recommendations in respect of ESG ratings and data products including recommendations for users of such ratings and products.

Copyright © William Fry 2021. All Rights Reserved

While IOSCO notes that "*almost all large asset managers are using or currently developing their own ESG ratings to supplement, or form part of their investment processes",* small and medium-sized managers are more reliant on ESG ratings and data product providers due to the cost-effective nature of outsourcing ESG data requirements. Furthermore, "*large asset managers tend to have contracts with several ESG ratings or data products providers to gather different perspectives of entities' ESG profiles for their internal processes, however, small or medium sized firms are unable to do so largely due to budget constraints."*

Given the prevalent use of ESG ratings and data products, which IOSCO notes does not often provide for user verification of the ratings and/or data, IOSCO considers there is scope for guidance "*to address the conduct of due diligence, or information gathering and review, and governance to help ensure mechanistic reliance on ESG ratings and data products is avoided where at all possible."*

IOSCO recommendation for users of ESG ratings and data products

IOSCO recommends that users of ESG ratings and data products conduct due diligence to understand "*what is being rated or assessed by the product, how it is being rated or assessed and, limitations and the purposes for which the product is being used.*" Users could consider evaluating the published methodologies of ESG ratings or data products including:

- the sources of information used in the product, the timeliness of this information, whether any gaps in information are filled using estimates, and if so, the methods used for arriving at these estimates;
- the criteria used in the ESG assessment process, including if they are science-based, quantitative, verifiable, and aligned with existing standards and taxonomies, the relative weighting of these criteria in the process, the extent of qualitative judgement and whether the covered entity was involved in the assessment process; and
- a determination as to the user's internal processes for which the product is suitable.

IOSCO also recommends that ESG ratings and data product providers increase transparency and prioritise adequate levels of public disclosure to enable users comply with the above-mentioned recommendations.

Next Steps

In January 2021, ESMA wrote to the Commission highlighting the need to match the demand for ESG ratings and data products with appropriate regulatory requirements to ensure their quality and reliability and avoid increased risks of greenwashing and mis-selling. Such regulatory requirements should be incorporated into existing supervisory and regulatory regimes (e.g. the CRA Regulation), to accommodate both large multi-national providers as well as smaller entities and provide for a common legal definition of an ESG rating, registration and supervision of providers of such ESG ratings, in addition to core requirements for their issuance.

While a response to ESMA's January recommendations is awaited, users of ESG ratings and data products should be cognisant of IOSCO's recommendations, compliance with which would be in line with regulatory expectations for the use of robust ESG ratings and data in order to prevent greenwashing.

Commission Q&A on UCITS Fee Rebates

On 26 November 2021, ESMA updated its UCITS Q&A document to include an answer provided by the Commission to a question on the rules applicable to UCITS management company fee rebate arrangements. Specifically, the question sought clarification on whether the payment of rebates by a UCITS management company from its own resources to individual investors is subject to UCITS inducement rules for safeguarding the best interests of investors. Such rules set down conditions for fees paid or received to/from a third party in relation to the activities of investment management and administration to the UCITS that ensure a UCITS management company acts honestly, fairly and professionally in accordance with the best interests of the UCITS.

In its response, the Commission confirmed that such UCITS management company fee rebate arrangements should be analysed for compliance with the UCITS inducement rules on the basis that they entail payments to certain investors based on fees charged by the UCITS management company to remunerate investment management and/or administration activities.

Accordingly, UCITS management companies must ensure, in respect of the fee rebate arrangement:

Copyright © William Fry 2021. All Rights Reserved

- prior disclosure to the UCITS, in a manner that is comprehensive, accurate and understandable, of the existence, nature and amount of the fee, commission or benefit or, where the amount cannot be ascertained, the method of calculating that amount; and
- that the payment of the fee or commission, or the provision of the non-monetary benefit:
  - is designed to enhance the quality of the relevant service. UCITS management companies should be able to demonstrate (through accurate and documented justifications) that the rebate arrangement will enhance the quality of the UCITS service to the benefit of all investors and not only to investors who benefit from the arrangement; and
  - does not impair compliance with the UCITS management company's duty to act in the best interests of the UCITS and, in particular, the duty to treat all unit-holders equally, act in the best interest of the unit-holders, and to refrain from placing the interest of any group of unit-holders above others. On that basis, UCITS management companies should be able to justify (through accurate and documented justifications) that all investors pay their fair share in the funds functioning (taking into account any management fee discount) and the UCITS cost structure and arrangements should not have a negative impact on other investors.

Next Steps

Existing UCITS fee rebate arrangements should be reviewed for compliance with existing UCITS inducement rules and the Commission's compliance expectations for such rules as outlined in the new Q&A, which serves as a clear reminder of the high benchmark for operating rebate fee arrangements within the structure of the fund and the applicable transparency rules.

Central Bank identifies inadequate compliance with MiFID client suitability rules

On 1 December 2021, the Central Bank published a 'Dear CEO' letter to MiFID firms detailing findings from the Central Bank's review of firms' compliance with the MiFID client suitability requirements. The Central Bank review, part of an ESMA-coordinated common supervisory action, was carried out in the course of 2020 and the findings were included in ESMA's public statement on the outcome of the CSA as published earlier this year.

MiFID client suitability rules require firms providing investment advice and/or portfolio management to take all reasonable steps to ensure a client's investments align to their objectives and personal circumstances.

While the Central Bank's review of firms' compliance with the above rules identified positive practices such as where firms took a 'personalised and comprehensive' compliance approach, its findings also set out areas for improvement including (i) gathering information to better inform firms assessment of clients' financial situation and capacity to withstand losses; (ii) ensuring suitability reports are both detailed and personalised to the client; and (iii) improving oversight of, and ensuring the issuance of clear risk warnings in, cases where a client insists on a transaction notwithstanding a firm's advice as to its unsuitability.

While the Central Bank is currently engaging directly on issues identified with specific firms, it also requires all MiFID firms providing advice and portfolio management services to retail clients to undertake a documented review of sales practices for compliance with the client suitability rules, identify any necessary remediations and arrange for Board approval of a remediation action plan by the end of Q1 2022. Future supervisory engagements by the Central Bank with firms will take account of firms' compliance with these requirements.

Operational Resilience Guidance Published by the Central Bank

On 1 December 2021, the Central Bank published cross-industry operational resilience guidelines (the **Guidelines**) for regulated financial service providers (**RFSPs**). The Guidelines, which were preceded by an industry consultation process (CP140) earlier this year, set out a recommended approach for ensuring operational resilience through the management of disruptive events under the three pillars of (i) identify and prepare; (ii) respond and adapt; and (iii) recover and learn.

Copyright © William Fry 2021. All Rights Reserved

The Guidelines, which are additional to and do not supersede RFSP governing regime rules, should be applied by RFSPs on a propionate basis taking account of a firm's nature, scale and complexity.

Why the current focus on operational resilience?

The Guidelines highlight three main drivers of the focus on operational resilience; accelerated dependence on technology (including as a result of the COVID pandemic), increasingly complex outsourcing structures; and notwithstanding recent international policy initiatives (e.g. forthcoming European Digital Operational Resilience Act (DORA)), the absence of one clear, detailed international standard for operational resilience. The Guidelines seek to address this last point by establishing a holistic approach to operational resilience management which will allow firms operating cross-border to develop operational resilience frameworks that address regulatory concerns arising from the increased levels of dependence on technology and outsourced service providers.

How does operational resilience management interact with existing operational risk and business continuity management?

"The Central Bank considers operational resilience to be the ability of a firm.. to identify and prepare for, respond and adapt to, recover and learn from, an operational disruption. The first step in becoming operationally resilient is accepting that disruptive events will occur, and that these events need to be managed effectively."

The focus of the Guidelines is on the establishment of a board-level, forward-looking framework which will facilitate a firm's effective management of risk events when they materialise. While RFSPs are already subject to, under their respective governing regimes and related regulatory guidance, requirements for the adoption and implementation of operational risk management frameworks with the objective of preventing and mitigating against such events, the necessity for operational resilience frameworks is born from the reality that such events will and do occur and firms should therefore prepare to effectively manage the consequential disruption to their operations. However, the Central Bank considers operational resilience to be *"an evolution"* of operational risk and, as such, firms' operational resilience management frameworks should be aligned with existing operational risk management frameworks but should go beyond minimising risk and focus on capabilities to deal with risk events when they inevitably materialise.

In addition to aligning with the operational risk management framework, firms' operational resilience frameworks should also draw from and seek to support the business continuity planning of RFSPs. While the Central Bank considers operational resilience to be "*much wider than just continuity and recovery",* as it also includes incident management and management of operational risk, third party risk, and IT and cyber risk, the continuity of critical or important business services is an essential component of being operationally resilient. Accordingly, the Central Bank recommends that operational resilience management frameworks align with and build on firms' existing business continuity plans.

When do firms need to implement the Guidelines?

The Central Bank expects firms to "*actively and promptly"* address operational resilience vulnerabilities and be in a position to evidence actions/plans to apply the Guidelines, at the latest, within two years of issuance of the Guidelines (i.e. by 1 December 2023). Evidence of actions/plans that the Central Bank will look for include:

- Board ownership and accountability for an adopted operational resilience framework;
- the Board seeking the required information to enable understanding of the risk and resilience profile of the firm and making targeted investment decisions to support ongoing resilience efforts;
- the firm developing an understanding of the delivery of critical or important business services, the people, the activities, information, technology, and third parties that support that delivery, and the criticality of those services to the wider financial system;
- determination of appropriate impact tolerances for critical or important business services and that they test their ability to remain within those impact tolerances under severe but plausible scenarios; and
- consideration of third parties in the response and recovery processes and that they are aligned and tested for effectiveness.

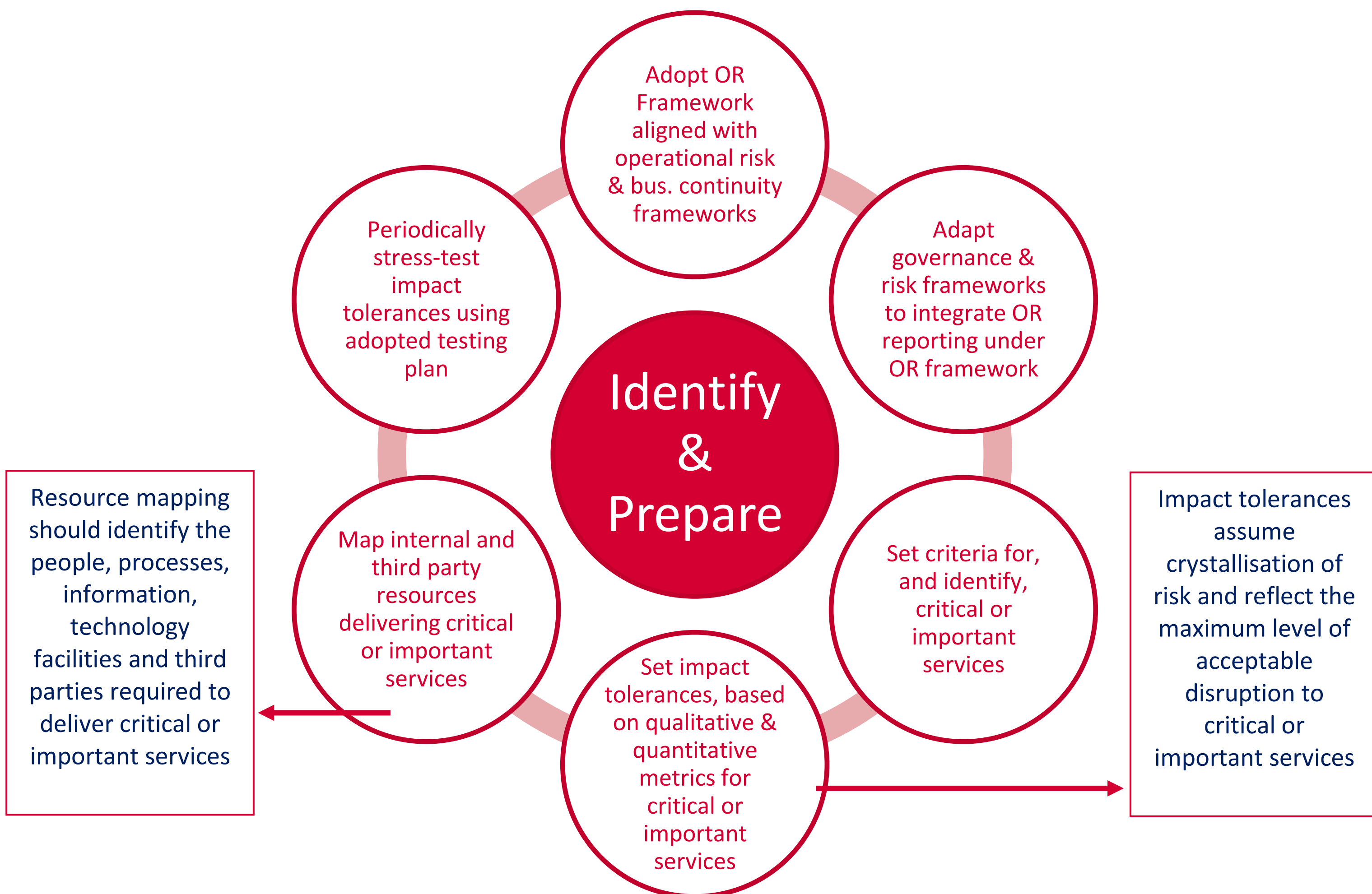
Copyright © William Fry 2021. All Rights Reserved

The Guidelines

As mentioned above, the Guidelines set out a three-pillar approach to operational resilience management.

Pillar 1: Identify & Prepare

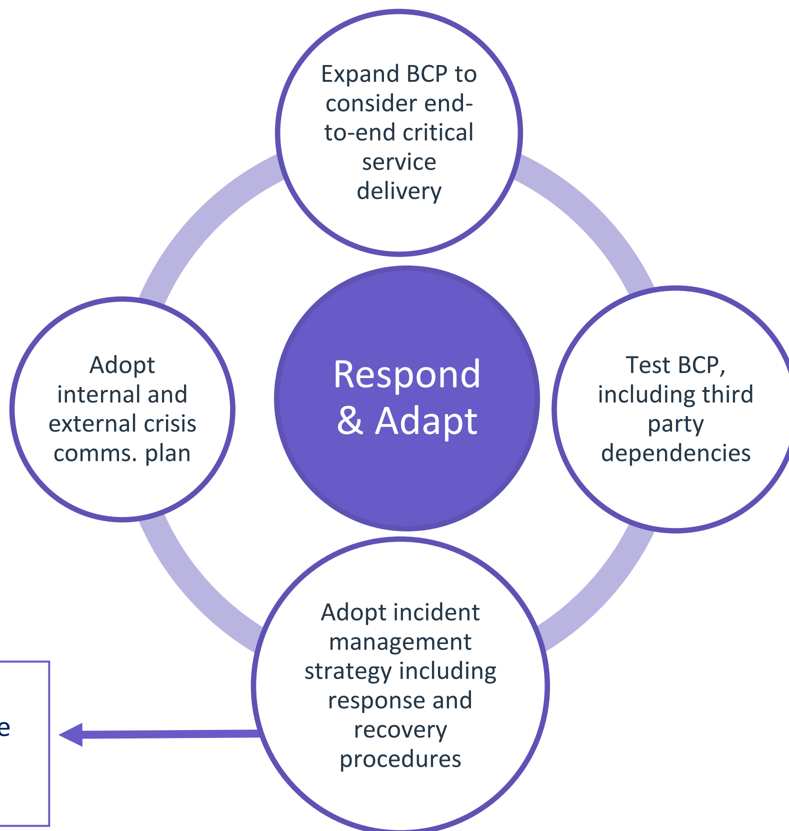
Under the first pillar of 'Identify and Prepare', there are six guidelines which, in summary, recommend the adoption and ongoing review (at least annually) by the Board of an operational resilience (**OR**) framework that provides for the classification of 'critical or important' services and the establishment of service impact tolerances setting out firms' maximum tolerance for disruption to critical services.



Copyright © William Fry 2021. All Rights Reserved

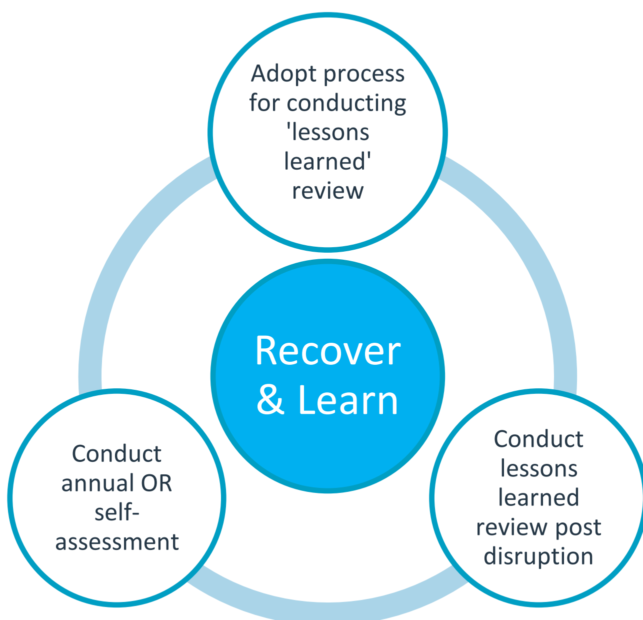
Pillar 2: Respond & Adapt

Under the second pillar of 'Respond and Adapt', there are four guidelines which, in summary, recommend that firms' OR frameworks incorporate an expansion of existing business continuity planning (**BCP**) beyond single-point failures to address continuity planning for critical services on an end-to-end delivery basis.



Incident management strategies should classify potentially disruptive incidents and identify appropriate responses

Pillar 3: Recover & Learn



Under the third pillar, the Central Bank expects firms' OR frameworks to provide for the performance of 'lessons learned' exercises after a disruption to a critical or important service including, for example:

- How and why the incident occurred;
- The identified vulnerabilities;
- The impact on the delivery of the service;
- Whether the risk controls, decisions and recovery processes and communications were appropriate; and
- The speed of recovery and whether the impact tolerances are adequate

Copyright © William Fry 2021. All Rights Reserved

WILLIAM FRY

DUBLIN | CORK | LONDON | NEW YORK | SAN FRANCISCO | SILICON VALLEY

William Fry LLP | T: +353 1 639 5000 | E: info@williamfry.com

williamfry.com

This briefing is provided for information only and does not constitute legal advice