WILLIAM FRY

Asset Management & Investment Funds Update

April 2023

Key Dates & Deadlines: Q2 2023

Date	Source	Summary	Action/Impact
2023 (date dependent on publication date of relevant financial report)		SFDR Level 2 – fund annual report disclosures SFDR Level 2 financial report disclosure rules, effective 1 January 2023, must be addressed in annual reports published after that date irrespective of the relevant financial or reference period.	Fund managers must ensure annual financial statements published after 1 January 2023, for funds subject to SFDR Article 7, 8 or 9, incorporate the relevant disclosures and using the Level 2 templates where applicable.
4 April		Crypto-Assets – revised Central Bank guidance for QIAIFs Central Bank published revised Q&A guidance permitting certain levels of indirect exposure to digital assets for QIAIFs, subject to compliance with specific disclosure and risk management requirements.	Revised regulatory guidance follows last year's in principle approval by the Central Bank of QIAIFs with exposure to cash settled Bitcoin futures. As a result of the revised guidance, open-ended QIAIFs with a 20% limit and limited liquidity/closed-ended funds with a 50% limit, on indirect exposure to digital assets and which comply with Q&A ID 1145 requirements are not subject to a regulatory pre-submission process.
12 April		SFDR Level 2 – consultation on amendments Included for consultation are proposals for an extended list of social PAI indicators and refinement of existing indicators, decarbonisation targets, further specification of the DNSH disclosure	The consultation is open until 4 July 2023.

		rule, simplification of the templates and other technical adjustments. Further details to follow a full review.	
14 April		SFDR – Third Commission Q&A expected Commission responses to ESAs' September 2022 SFDR questions published. See article on topic in this month's edition.	Responses clarifying key topics of sustainable investments, principal adverse impacts and emission reduction objectives will be highly relevant to many fund managers.
20 & 24 April		F&P - new PCF application process PCF IQ applications can be submitted via the F&P section of the ONR until 5pm on 20 April. From 24 April onwards PCF IQs should be submitted via Portal using the revised IQ. See here for further details.	ONR access will be via Portal from H2 2023. ONR users should set up a Portal account (if not already registered) and link it to their ONR account to avoid any disruption once standard ONR logins are disabled and to facilitate filing of IQs post 24 April.
28 April		ESMA Guidelines for MMF Stress Tests – consultation closed ESMA is consulting on proposed revisions to the liquidity and macro scenarios to reflect redemption pressures and macroprudential concerns. See here for further details.	Consultation response deadline.
3 May		EU Taxonomy – consultation closed Consultation on technical screening criteria for assessing activities' contribution to four non-climate environmental objectives opened on 5 April and closes on 3 May. See here for further details.	Consultation response deadline.
30 June		SFDR- first entity-level PAI statements due and second calculation date in current reference period First full PAI statements are due for publication reflecting the entity-level PAIs of investments as identified on at least four calculation dates during the initial reference period of Jan – Dec 2022. See here for further details. CSRD – first set of reporting standards due for adoption The Commission will adopt the draft reporting standards published by EFRAG last November as CSRD delegated acts and these will be applicable from the first effective date of CSRD of 1 January 2024. See here for further details.	SFDR Level 2 requires entity-level PAIs to be disclosed using the template PAI statement at Annex I which must be published by the 30 June deadline on the website of the relevant entity.

Commission publishes 3rd SFDR Q&A

On 5 April last, the Commission issued its third SFDR Q&A with responses to questions raised by the ESAs last September and revisions to certain previous Q&A which did not align with the positions now being set out in the latest Q&A, as summarised below.

- Article 9 funds with a carbon emission reduction objective are not required to track a PAB/CTB: the Commission's first, July 2021 Q&A has been amended and reissued to remove guidance for Article 9 funds with a carbon emission reduction objective to track a Paris-aligned or Climate Transition Benchmark (PAB/CTB), which has been replaced by a clarification that SFDR does not prescribe any single methodology to account for sustainable investments.

- PAB/CTB trackers deemed to have a sustainable investment objective: in a new Q&A, the Commission clarifies that Article 9 funds with a carbon emission reduction objective have discretion as to the investment strategy used to achieve that objective and such funds, whether passively or actively managed, are subject to Article 9(3). However, where a fund seeks to achieve a carbon emission reduction objective by tracking a PAB/CTB, the fund will not be subject to Article 9(3)(2) disclosure as it is deemed to have a sustainable investment objective. Article 9(3)(2) requires a detailed explanation of how the continuous effort to achieve the fund's objective is ensured in view of the Paris Agreement objectives. Only funds which do not passively track a PAB/CTB are subject to this disclosure rule and are therefore required to explain why the fund is considered to have a sustainable investment objective and also to make required Level 2 disclosures explaining the extent to which the fund complied with the methodological requirements for PAB/CTBs under the BMR. Notably, while the Q&A confirms that PAB/CTB trackers are deemed to have a sustainable investment objective, challenges may remain for such funds' completion of SFDR Level 2 disclosure templates in circumstances where index providers are not subject to equivalent disclosure obligations.

- Fund managers are responsible for sustainable investment methodologies: despite detailed interpretative queries from the ESAs, the Q&A does not further specify the definition of sustainable investments under SFDR. Instead, the Commission confirms the responsibility of fund managers to develop their own methods for assessing sustainable investments, noting that SFDR does not prescribe any 'minimum requirements' for the contribution, do no significant harm, or good governance requirements for sustainable investments. The Commission also clarifies that, despite the reference to sustainable investments as investments in 'economic activities' under SFDR, it is possible to apply the sustainable investment test at the level of an investee company and not only at the level of its specific activities. This clarification issued in response to the ESAs' question of how an investment in a company can be a sustainable investment where, for example, the company has one activity, among several other activities, that contributes to an environmental or social objective. This Q&A largely maintains the status quo with fund managers continuing to be responsible for constructing sustainable investment methodologies and absent any additional guidance from legislators/regulators.

- Article 8 funds can target carbon emissions reductions as an environmental characteristic: **s**imilar to the Article 9 clarifications, the Q&A confirms that SFDR does not limit the investment strategies available to funds in scope of Article 8. As a result, Article 8 funds' environmental characteristics may target reduced carbon emissions, although the Commission notes that investor disclosures for such a fund should not mislead investors into thinking that the target equates to a sustainable investment objective for the fund.

- Product-level PAI consideration includes identification and mitigation: fund managers that comply with entity-level PAI consideration rules under SFDR Article 4 must disclose whether and, if so, how PAIs are considered for relevant underlying products. In response to the ESAs request for clarification of the term 'consider', the Commission confirms that product-level PAI disclosures must include both a description of the PAIs and the procedures in place to mitigate those impacts.

- Calculation of 500-employee threshold for mandatory entity-level PAI consideration rule: the Commission confirms that the term 'employee' is not defined under SFDR and must therefore be determined by reference to the definition set out in applicable national law.

- Periodic product-level disclosures required only annually by investment firms: while periodic disclosures by investment firms for Article 8 or 9 products are required to be included in the quarterly client report issued under relevant MiFID rules, as SFDR only requires such disclosures to be made annually, they need only be included in every fourth client report issued under MiFID rules.

AIFMD Review Series: UCITS Proposals

Trilogue negotiations of the AIFMD Review text are underway and parties continue to target an agreed text by year end. Assuming the two-year transposition period is retained, this means proposals may be applicable from end 2025.

Following on from the first in this series on the key topics of delegation and substance; the following looks at five key proposals for UCITS managers to watch out for during the legislative process.

Overview of UCITS Proposals under the AIFMD Review

UCITS proposals under this initiative primarily target improved alignment of UCITS rules with either the existing AIFMD regime or the AIFMD proposals (once finalised and adopted). Helpfully, some of the alignment proposals correct obvious and unnecessary discord between the regimes, for example by broadening the list of non-core services to include receipt and transmission of orders and permitting the use of side pockets as a liquidity management tool (**LMT**). However, certain of the proposals will present challenges, in particular the proposed increase in supervisory reporting (both ad hoc and periodic) and the application of AIFMD Level 2-style delegation rules to UCITS managers in line with the ESMA Brexit Opinion on investment management.

Top 5 UCITS proposals

1. *Enhanced supervisory reporting including on delegation and liquidity arrangements*

Commission proposal for AIFMD-style reporting: UCITS managers must report regularly to NCAs on the markets and instruments traded and subject to forthcoming ESMA regulatory technical standards on the format, data standards, frequency and timing of supervisory reports.

*Council and Parliament views***:** both support the proposal but also specify enhancements to further align the proposal with the current AIFMD supervisory reporting requirement (which itself is proposed for replacement under AIFMD proposals discussed here).

Council and Parliament delegation reporting proposal: UCITS managers must report regularly to the home NCA on arrangements for the delegation of portfolio or risk management functions including delegate details, resources of the delegate for performing the delegated functions and of the UCITS manager for delegate monitoring, whether the delegation represents a full or partial delegation of the function, any sub-delegation arrangements in place, confirmation of periodic due diligence of the delegate and records evidencing same.

Council and Parliament liquidity reporting proposal: UCITS managers must report to the home NCA on its liquidity risk management arrangements including the use of LMTs, underlying UCITS' risk profiles and relevant stress testing results.

Commission LMT reporting proposal: UCITS managers must promptly notify both home and host NCAs of any activation or deactivation of LMTs.

Council and parliament views: both support the proposal, but the Parliament limits the notification obligation to where side pockets are used and LMTs used in response to liquidity stress or otherwise than in the ordinary course of business. Whereas the Council proposes differing timings depending on the type of LMT triggered e.g., notification 'without delay' for suspension or gating but 'in a reasonable timeframe prior' to the use of side pockets.

2. *Delegation and substance rules amended to align with existing and proposed AIFMD and Level 2 requirements*

Commission delegation proposal: UCITS managers that delegate more portfolio or risk management to third country entities must provide an annual notification to ESMA including of delegate details and as to the functions retained and those delegated. The Commission also proposes clarifying the application of delegation rules to all Annex I functions and any authorised ancillary/non-core services and extending those rules to require UCITS managers to justify delegation structures based on objective reasons and adhere to forthcoming delegated measures for the letter-box rule (which are expected to formally apply AIFMD Level 2-style delegation rules to UCITS).

Council and Parliament views: neither Parliament nor Council support the proposed annual notification to ESMA and instead propose increased levels of NCA reporting (see 1. above) to enhance regulators and legislators understanding of relevant market practices.

Commission substance proposal: UCITS managers must employ at least two full-time persons or otherwise engage two persons on a full-time basis who are resident in the EU.

Council and Parliament views: both support the proposal, with Parliament additionally allowing for full-time equivalent commitments and Council allowing for full-time board members to meet the requirement.

Parliament substance proposal: UCITS managers must appoint at least one independent, non-executive director and take steps to ensure all non-executive directors have sufficient experience and expertise to manage UCITS in the best interests of investors.

3. *LMT proposals including increased regulatory powers to direct activation*

Commission proposal: UCITS managers must select, in addition to suspension, at least one other LMT from the harmonised list of LMTs which Member States will be obliged to make available for use by managers in their jurisdiction. NCAs will have the power to require UCITS managers (in addition to their existing power to require the suspension of dealing) to activate or deactivate redemption gates or another LMT selected and notified by the UCITS where it is in the interest of investors or of the public and subject to forthcoming delegated measures setting down the situations in which this power may be exercised.

Council and Parliament views: while the Parliament supports extending NCAs' powers to direct activation of redemption gates, the Council does not. The Council also proposes limiting the use of redemptions in kind to requests from professional investors and to those that correspond to a pro rata to the share of assets held (other than in the case of professional investor, index-tracking and ETF UCITS).

4. *Enhanced application for authorisation to include additional details of delegation arrangements*

Commission proposal: extend the level of information required as part of the authorisation application to include additional detail on the manager's resources to carry out its functions and those in place to monitor and oversee delegates.

Council and Parliament views: both support the proposal, with the Parliament proposing enhancements including additional information on delegation arrangements including as to full or partial delegation status, delegate details, an explanation of the added value of the delegation for investors and post-authorisation reporting of any material changes. The Parliament also proposes the adoption of delegated measures to standardise and templatise the enhanced authorisation application and to specify situations where the name of proposed underlying UCITS may be 'materially deceptive or misleading to the investor' (possibly with the intention to legislate for the upcoming ESMA fund name guidelines).

5. *Distributors act on their own behalf and are not delegates*

Council and Parliament proposal: clarify that distributors act on their own behalf and market under MiFID licences or through insurance-based investment products and should not therefore be considered delegates of the UCITS manager, irrespective of any distribution agreement between the UCITS manager and distributor.

Commission view: the proposal does not appear in the Commission's review; however, it appears somewhat at odds with the Commission's July 2022 Q&A on distribution. In the Q&A, the Commission clarifies the application of UCITS delegation rules to the marketing function and 'the principle of full responsibility of fund managers' for delegation of that function. The Commission also states that fund managers are responsible for compliance with the Cross-Border Distribution of Funds regime, irrespective of who is actually distributing the fund and whether the fund manager has a contractual or other relationship with that distributor.

Next steps

Further details to follow as the proposals progress through the EU legislative process.

Revised Central Bank Guidance for PRIIPs KID Filings

On 24 March, the Central Bank published its 4th Markets Update of 2023 including revised website and Q&A guidance for filing PRIIPs KIDs.

The revised PRIIPs guidance takes account of comments raised by William Fry on the December 2022 guidance in respect of the prioritisation of UCITS KIIDs over PRIIPs KIDs which appeared to conflict with the Commission's interpretation of the rules. Unfortunately, however, it does not address comments in relation to the filing requirements for new share class KIDs of existing funds with the Central Bank only promising to issue further revised guidance for such filings.

What's changed under the revised guidance?

1. New funds (umbrellas/sub-funds authorised post-1 January 2023) subject to PRIIPs are required to file a PRIIPs KID, irrespective of whether only a PRIIPs KID is produced or both a KID and a UCITS KIID.
2. Existing funds (umbrellas/sub-funds authorised pre-1 January 2023) subject to PRIIPs are no longer required to file PRIIPs KIDs as the Central Bank cannot yet accept such filings. The Central Bank will issue further revised guidance on the PRIIPs regulatory filing obligations of these funds.
3. New Q&A guidance has also issued confirming that a UCITS KIID may be submitted for professional-only share classes (as such share classes are not subject to PRIIPs rules so it may be that only a UCITS KIID is available for filing) and that non-Irish UCITS which intend to market to Irish retail investors should file a PRIIPs KID as part of the passporting notification to its home regulator.

Revised Guidance for new (post-1 Jan) funds

In line with the Commission Q&A on topic, new umbrellas and/or sub-funds subject to PRIIPs which produce both a PRIIPs KID and a UCITS KIID are required to file the PRIIPs KID. Unfortunately, it has not been made clear that the PRIIPs KID should be filed instead of the UCITS KIID where both are produced. A case-by-case analysis may be necessary in such circumstances, taking account of the reasons for producing any UCITS KIID and the law governing its production.

PRIIPs KIDs for new funds should be filed as part of the authorisation day submission, whether by email for new umbrellas or via ORION for new funds. Amendments to such KIDs, must be filed through Portal using the 'UCITS KIID Update' Request Changes.

To implement the changes for new funds, the Central Bank has:

- amended its website guidance to confirm that new funds subject to PRIIPs must file a PRIIPs KID with the Central Bank
- amended UCITS Q&A ID 1107, to remove reference to UCITS KIIDs, and
- deleted its UCITS Q&A ID1108 stating that where a new fund produces both a PRIIPs KID and a UCITS KIID, only the UCITS KIID should be filed with the Central Bank. We had commented on this Q&A, noting that it appeared at odds with the Commission's PRIIPs Q&A requiring PRIIPs KIDs to be filed to meet the key information notification obligation for UCITS subject to PRIIPs.

Revised guidance for existing (pre-1 Jan) funds

The requirement for existing funds to file new PRIIPs KIDs has been deleted and replaced with confirmation that the Central Bank does not require existing funds to file PRIIPs KIDs at this time. Further guidance will issue from the Central Bank on the PRIIPs KID filing requirements for these funds.

The revised guidance also confirms that Portal cannot be used to file new PRIIPs KIDs e.g., for new share classes of existing funds.

To implement the changes for existing funds, the Central Bank has:

- amended its website guidance including deletion of the statement ' In the case of existing UCITS, a new PRIIPs KID or an amended PRIIPs KID and the confirmation from the responsible person or its legal advisor should be submitted via Portal using the "UCITS KID Update" Request Changes.', and
- amended UCITS Q&A ID 1109 to refer to the above position (see attached mark-up).

Next Steps

Newly authorised (since 1 January 2023) funds should comply with the Central Bank's guidance for filing PRIIPs KIDs and existing funds must await further guidance for clarity on their obligations.

Central Bank tells fund managers to prioritise oversight and calibration of costs and fees

On 24 March 2023, the Central Bank published its findings from the 2021 UCITS CSA on costs and fees, noting that **'the oversight and calibration of costs and fees should be made a priority for UCITS'** and that certain such matters would **'be an area of focus for the Central Bank in future supervisory engagements'** given the level of deficiencies identified.

During the CSA, the Central Bank assessed a sample of 59 UCITS managers' compliance with their obligations not to charge undue costs, to act in investors' best interests and to comply with UCITS rules for use of efficient portfolio management (**EPM**) techniques and connected party transactions.

While the CSA was specific to UCITS managers, the Central Bank expects AIFMs to also consider the CSA findings and its expectations when setting AIF cost and fee structures.

All fund managers are required to do a gap analysis against the CSA findings and put in place an action plan for any identified gaps by end Q3 2023.

Central Bank's CSA findings align with ESMA's but also include jurisdictional-specific findings

The Central Bank's findings follow on from, and are broadly aligned with those issued by ESMA in May 2022. Like ESMA, the Central Bank did not find that material undue costs are being charged to investors but did identify deficiencies in UCITS managers governance of fee structures.

The findings are summarised in the table below. Notably however, both regulators have now issued expectations for UCITS managers to:

- ensure undue costs are not charged by having in place formalised, structured pricing process
- carry out periodic (at least annual) reviews of costs and fees to ensure viability and competitiveness over time
- avoid over reliance on the assessment of delegate investment managers and perform independent review of costs and fee structure
- ensure fee structures offer investors return commensurate with risk profile
- establish/improve existing EPM policies and procedures and ensure specific offering document disclosures on the use of such techniques

Going beyond the findings of ESMA, the Central Bank also published CSA findings on the use of fixed operating expense (**FOE**) models and non-discretionary investment advisory fees by Irish UCITS managers:

Fixed Operating Expense (FOE) models result in relatively higher revenue for fund managers and are supervisory focus: the Central Bank expects FOE models to be reviewed annually, calibrated to minimise the difference between fund expenses and the fixed fee, and operate such that investors are 'fully aware' of all expenses. The Central Bank found that the calibration of FOE levels by relevant sampled managers led to managers almost always receiving additional income (in some cases up to 0.15% of NAV) as a result of using the FOE model. As a result, the Central Bank's future supervisory work programme will focus on FOE models.

Non-discretionary investment advisory fee greater than that of the investment manager indicative of de-facto management role: the Central Bank's CSA findings reiterate its previously published concern arising from fee structures with an investment advisory fee greater than that of the investment manager – this is considered indicative of an inappropriate level of influence/control on the part of the advisor and of a fee structure that is not in the interests of investors. The Central Bank again confirms its expectation that investment advisors are limited to a non-discretionary role, supplementary to that of the investment manager (see Central Bank AIFMD Q&A ID1151 and 2022 Securities Markets Outlook Report for further details of this regulatory concern).

Costs and Fees CSA Findings

The following table includes (i) the CSA findings/expectations common to both the Central Bank and ESMA and (ii) any additional CSA findings/expectations from ESMA (as set out in its May 2022 Final Report).

As the Central Bank's findings require them to be read in conjunction with ESMA's findings, both columns should be taken into account for the gap analysis/action plan required by end Q3 2023.

Both ESMA and the Central Bank expect fund managers to take into account the terms of the June 2020 ESMA Supervisory Briefing on the Supervision of Costs when complying with the following expectations:

	Central Bank / ESMA CSA Findings / Expectations	Additional ESMA CSA Findings / Expectations
Pricing process	All UCITS managers are expected to have structured, formalised pricing processes supported by policies and procedures (**P&Ps**) which: • provide for the design, oversight and regular review of costs and fee structures • are overseen and approved by senior management • allow for transparent identification and quantification of all costs charged to the fund • provide for fair and equitable calculation of costs and fees, in the best interests of investors • provide for fee structures that ensure investors continue to be offered a return commensurate with the risk profile of the fund • avoid over-reliance on delegate investment managers for setting the fee structure • provide for adequate Board reporting that allows for regular review of costs and fees	• Key to setting the pricing structure is the analysis of the sustainability of costs over time and/or the relative weight of fees on the investor's return based on the different market scenarios • Regular stringent controls by internal control functions should be ensured as part of the process • Comparison with peer funds should not solely be used by fund managers in order to set the pricing of the fund, but each cost category should be separately assessed and determined in the investor's best interest • The principle of proportionality may justify less sophisticated processes but should not result in a full disapplication of the requirement to have in place a structured and formalised pricing process in line with the ESMA briefing on the supervision of costs. ESMA considers the risk of undue costs may be higher in the case of smaller funds/UCITS managers • Intragroup/related-party transactions can result in higher costs and/or costs higher than average
Periodic (at least annual) review of costs and fee structures	All costs and fees charged (both new and existing) should be subject to a documented review, at least annually, including the methodology used to calculate fees. The costs and fees review should: • consider appropriateness in light of types of funds under management, actual versus target level of fund performance and role and responsibilities of relevant service provider • consider viability and competitiveness of funds in terms of being capable of	The purpose of the periodic review should include, where possible, reducing the level of fees and ensuring the viability and competitiveness of the fund over time against peer funds

	providing a positive return to investors • ensure investors continue to be offered a return commensurate with the risk profile of the fund • ensure costs and fees calculation in a fair and equitable manner, in the best interest of investors • include fixed operating expense (FOE) models and compliance with UCITS undue costs principle • include fee arrangements for all EPM activities	
Independent (of the delegate investment manager) review	Fund managers without a documented pricing process tend to over-rely on delegate investment managers for setting fees, indicating a lack of engagement and oversight. Independent reviews of costs and fee structures should be performed and over-reliance on the assessment made by the delegate investment manager should be avoided	
EPM	• Managers using EPM must have formalised P&Ps covering EPM activities which clearly disclose fee arrangements for securities lending programmes. A significant majority of managers using EPM did not have formalised P&Ps and those that did had insufficiently detailed P&Ps • Fund offering documents must clearly disclose the EPM strategy, risks of that strategy, and fee arrangements for specific EPM techniques being used • Fees for securities lending arrangements must comply with ESMA's expectations, be clearly disclosed in fund offering documents, captured in EPM P&Ps and reviewed on a planned and systematic basis. Several sampled managers retain significantly more revenue than their peers (between 30-40%) from their programmes.	• The absence of EPM policies and procedures constitutes a breach of regulatory obligations • Offering document disclosures of a theoretical possibility of using EPM is not in line with the ESMA Guidelines on ETFs and other UCITS issues – boilerplate disclosures that do not clearly inform investors of specific arrangements and risks cannot ensure compliance with these Guidelines • Fee-split arrangements, involving the deduction of securities lending agents' fees from EPM revenue generated, merit further investigations and analysis as it appears there is limited consideration of fair market rates when entering into such arrangements, in particular intra-group arrangements.

Next steps

All fund managers (UCITS managers and AIFMs) are required to do a gap analysis against the CSA findings and put in place an action plan to address identified gaps by end Q3 2023.

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