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Time for an Upgrade: Central Bank of Ireland Replaces UCITS Notices and Guidance Notes with Statutory Instrument

A legal update from Dechert's Financial Services Group

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For more than 25 years, the essential text for anybody wishing to navigate the regulatory environment for UCITS in Ireland has been the UCITS Notices which were supplemented by UCITS Guidance and then the UCITS Q&A.

This infrastructure has been subject to a detailed review by the Central Bank of Ireland (the "Central Bank") and, on 1 November 2015, the UCITS Notices were decommissioned and replaced by the Central Bank (Supervision and Enforcement) Act 2013 (section 49(1)) (Undertakings for Collective Investment in Transferable Securities) Regulations 2015 (the "Regulations"). The Regulations are supplemented with thematic online guidance (the "guidance") and a UCITS Q&A.

While largely a consolidation and tidy up of the previous UCITS Notices and Guidance Notes regime, there are some significant changes that will come into effect for both existing and future Irish UCITS. This OnPoint provides information regarding (i) the background to the Regulations; (ii) the layout and format of the Regulations; (iii) changes to the existing regulatory conditions; (iv) transition timelines; (v) expected changes to the Regulations in the near future; and (vi) other miscellaneous provisions of which readers should be aware.

The Central Bank issued an updated UCITS Q&A on 4 November 2015, which provided a number of clarifications to the implementation to the Regulations. The information in this Q&A is included herein.

If It Ain't Broke! - Background to the Development of the Regulations

The Central Bank issued a consultation paper (CP 77) in the autumn of 2014 in relation to the publication of a UCITS Rulebook which would consolidate the existing UCITS Notices and Guidance Notes. The proposal for a UCITS Rulebook was a follow on from a similar consolidation exercise undertaken for alternative investment funds ("AIFs") following the implementation of the Alternative Investment Fund Managers Directive (the "AIFMD") in which the Non-UCITS Notices and Guidance Notes were replaced by the AIF Rulebook in 2013. In CP77, the draft UCITS Rulebook was modelled on the template of the AIF Rulebook.

The aim of the Central Bank was to avoid duplication and to clarify the status of its guidance as something that "does not clearly constitute a regulatory requirement".

The Central Bank determined that the UCITS Rulebook would be issued on a statutory basis in the form of a statutory instrument. This change links the sanctioning powers of the Central Bank under the Central Bank Acts to the UCITS Regulations. It also provides further transparency and clarity to users and to other jurisdictions on the Central Bank's rules.

In addition to CP 77, the Central Bank issued CP 84 - Consultation on the adoption of the European Securities and Markets Authority's ("ESMA") revised guidelines on ETFs and other UCITS issues (the "ESMA Guidelines"). This consultation considered the implementation of certain of the ESMA Guidelines in Ireland, particularly those relating to collateral diversification and collateral able to be received by a UCITS. The Central Bank's determinations on the implementation of the ESMA Guidelines following CP 84 are included as provisions in the Regulations.

The Central Bank worked with, and continues to consult with, the Irish Funds (formerly the Irish Funds Industry Association) UCITS Rulebook Working Group on the proposed regulations, guidance and Q&A. On 5 October 2015, the final Regulations were issued and came into effect on 1 November 2015.

How Do the Pieces Fit Together? - Format and Layout of the New Regime

While the Regulations are essentially the UCITS Notices and Guidance Notes in a different guise, it should be noted that the format has changed significantly. Specifically, text from the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011, as amended (the "Directive Regulations"), which implemented the UCITS Directive into Irish law, was often recited in the UCITS Notices and then expanded upon. That is no longer the case.

The new format is as follows:

- There is no repetition of the text of the Directive Regulations; therefore, users should default to the Directive Regulations.
- The rules or conditions imposed by the Central Bank (including those that are adopted by the Central Bank from guidelines issued by ESMA) are now in the Regulations.
- Provisions which constitute guidance are set out in non-mandatory guidance on the Central Bank website.
- Clarifications are included in the UCITS Q&A.

While the Regulations may be less "user friendly" than the Notices, there is less chance of discrepancies between the Directive Regulations and the Regulations as there is no overlap between the two. It is also clear now what is and is not mandatory, as the Regulations are required to be complied with (unless you receive a waiver) and the guidance is expected to be followed on a "comply or explain" basis.

The structure of the Regulations is similar to the AIF Rulebook whereby there are different "Parts" which address in themed sections specific matters. These include, inter alia:

- Restrictions on UCITS, which includes general restrictions, investment restrictions, dealing, etc.
- Supervisory Requirements, which includes items such as monthly and quarterly returns and other matters involving regulatory engagement such as replacement of a service provider.
- Other sections which do more or less what they say on the tin, including Prospectus Requirements, Key Investor Information Document Requirements and Annual and Half-Yearly Reports of a UCITS. There are also separate parts for management companies and depositaries.

The Regulations also include detailed Schedules which address matters such as collateral, calculation of global exposure and managerial functions of the management company.

The UCITS Q&A is an important feature and should not be overlooked as it is the mechanism by which the Central Bank will issue clarifications on compliance with the Regulations.

What's New? – Policy Changes

While most of the changes can be put down to style over substance, there are some specific policy changes. In this section, we set-out high-level details of these changes. This list is not exhaustive and the Regulations should be looked at on a case-by-case basis for each UCITS.

A. Removal of the Promoter Approval Regime

Previously, UCITS have been required to have a promoter that was pre-approved by the Central Bank as being of good repute, having sufficient financial resources and a relevant track record in the promotion/organisation of collective investment schemes. Most importantly for small to medium sized managers, promoters were required to hold and maintain at least €635,000 in net shareholders' funds. For many, this requirement varied from the inconvenient to the insurmountable as it exceeded their domestic regulatory capital requirements.

The AIF Rulebook removed this requirement for AIFs and the Central Bank has now also done so for UCITS. It should be noted, however, that the Regulations require that the identity of the group that is promoting the UCITS is identified and described in the prospectus. The Central Bank traditionally placed significant reliance on the promoter approval requirement but it lacked a regulatory or statutory basis for doing so, particularly following the UCITS management company directive and AIFMD.

In removing the promoter approval requirement, the Central Bank will be placing (greater) reliance on the regulatory regime for UCITS management companies and on the obligations of directors. This greater reliance is underpinned in various corporate governance and oversight measures that the Central Bank has been undertaking recently. These measures include: the change to the use of the "responsible person" term throughout the Regulations (ensuring it is clear who is responsible for compliance with the Central Bank's rules, as discussed further below) and the changes to management company structure and oversight responsibilities issued pursuant to the CP86 – Consultation on Fund Management Company Effectiveness – Delegate Oversight ("CP 86"), which applies to both UCITS and AIFs. Please refer to the separate Dechert OnPoint on CP 86.

CP 86 shows the Central Bank's focus on clarifying the role of directors and ensuring the effective management of UCITS, both those which utilise external management companies and self-managed UCITS. The Regulations have implemented the alteration, pursuant to CP 86, of the UCITS management company managerial functions, reducing them from 10 functions which covered very specific areas to 6 functions which are broader in nature. In addition, CP 86 discusses the new overarching role for each UCITS management company/self-managed entity related to organisational effectiveness, which will focus on the ongoing operations of the structure. Another aspect of CP 86 deals with the time commitment of directors to UCITS management companies/self-managed entities. The time commitment guidelines assist in providing insight into what levels of commitment (to directorships and/or professional commitments) the Central Bank considers to require further consideration about a person's ability to effectively carry out his or her role.

In addition to its focus on UCITS management companies and directors, the Central Bank will still require discretionary managers of Irish UCITS to be regulated, subject to prudential oversight and to be satisfied as to its expertise, integrity and adequacy of financial resource. The timeframe for this should not be underestimated.

The approval process for this effectively mirrors the process that was in place for promoters without the capital requirements.

B. Responsible Person and Enforcement

A key change to the Regulations is the identification of a "responsible person" in virtually every section. This term is used throughout the Regulations to denote the party that is subject to sanction for non-compliance. The responsible person is the management company or, for self-managed investment companies, the UCITS itself. In the case of provisions relating to the change of management company, the term refers to the UCITS itself. Although the UCITS Notices did provide that compliance with the Directive Regulations and the UCITS Notices was the obligation of the UCITS or the management company (where appointed), the solidification and implementation into the provisions of the Regulations provides clarity on this point.

While the responsible person may delegate the carrying out of a particular task, it still remains the obligation of the responsible person to ensure that task is done in compliance with the Regulations. As such, the responsible person must be very careful to ensure that all activities are being carried out and that proper oversight of delegated actions is maintained.

The Central Bank's enforcement powers under the Central Bank Act 1943, as amended and the Central Bank (Supervision and Enforcement) Act 2013 include a number of mechanisms by which the Central Bank can enforce financial services legislation, including the Regulations.

These powers include, inter alia, the ability to:

- Institute summary proceedings (criminal prosecution) for an offence under financial services legislation.
- Institute Administrative Sanctions, which can result in:
  - the issuance of a supervisory warning; or
  - a settlement agreement (which may include a reduction in sanctions/fines).
- Issue sanctions such as:
  - reprimands;
  - monetary fines;
  - disqualification of a person from management of a financial services company;
  - suspension of authorisation for up to 12 months; and
  - revocation of authorisation.

C. Regulated Markets to be Determined by the UCITS

UCITS are designed to trade in securities listed or traded on a regulated market (with some exceptions, including the exempt 10% of net assets in transferable securities not listed or traded on a regulated market). The determination of what constituted a regulated market was the subject of the first Guidance Note issued by the Central Bank (Guidance Note 1/96).

Guidance Note 1/96 has been withdrawn and it is now the responsibility of the UCITS or its management company to determine whether or not a market is regulated for the purposes of the Directive Regulations (the depositary should also be involved in this discussion). The Central Bank also provides updated guidance on what the criteria for determining whether a market is regulated (i.e. regulated, recognised, operating regularly and open to the public (the "Regulated Criteria") mean. As part of this information, which is included as a schedule to the Regulations, the Central Bank helpfully notes that the responsible person should have regard to issues which would be relevant to the operation of the market and investments therein as well as whether the relevant market displays any or each of the Regulated Criteria.

While there is a significant onus on UCITS to ensure that securities invested in meet the Regulated Criteria, the withdrawal of the Guidance Note does permit flexibility with regard to the determination to be reached e.g. with regard to Rule 144A securities issued without registration rights.

D. Long/Short Strategies

Recently, the Central Bank has requested that UCITS utilising long/short strategies include, within the investment policy, details as to which financial derivative instruments are utilised to take long positions, short positions or both and an indication of the percentage or ratio of long exposures to short exposures expected to be maintained.

In relation to the disclosure of the percentage of long and short exposures, the Central Bank has clarified in its Q&A that this should be the anticipated range for long and short positions and it is up to the UCITS to determine whether the percentages should be disclosed on a net or gross basis, provided the prospectus clearly discloses the basis selected.

These requirements are now embedded in the Regulations applicable to all new UCITS and will be required to be updated for existing UCITS in line with the transitional provisions detailed below.

E. Collateral

The rules relating to the receipt of collateral for derivative positions has undergone two changes which should be noted relating to diversification and collateral issuer credit rating.

1. Collateral Diversification

UCITS engaging in financial derivative transactions will often take collateral as part of the management of those positions. The general rule is that UCITS are required to ensure adequate diversification of collateral received in terms of country, markets and issuers with a maximum exposure to a given issuer of 20% of the net asset value. In addition, where different baskets of collateral are received from different counterparties, the baskets must be aggregated for determining this limit.

Following CP 84, the Central Bank has implemented ESMA's proposal to provide a derogation from these requirements and permit full collateralisation in different transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong provided the securities are from at least six different issues and no single issue shall make up more than 30% of the UCITS' net asset value.

The confirmation of the adoption of this provision has been long awaited by many UCITS managers and aligns with the investment restrictions provision which permits full investment in similar transferable securities under the same provisions.

It should be noted that any UCITS that wishes to take advantage of this flexibility will need to disclose in its prospectus the intention to be fully collateralised in this manner and such UCITS may not utilise this flexibility until such amendment is made to the prospectus. UCITS should also identify the issuers of the securities which they are able to accept as collateral for more than 20% of their net asset value.

2. Collateral Issuer Credit Quality

One of the concerns of the Central Bank in the matter of adopting the collateral diversification flexibility was over deterioration of credit quality of a collateral issuer, particularly in distressed markets. The main concern was the

vagueness of the provision that the UCITS may only accept collateral that is "high quality" and the possibility that a UCITS may hold on to collateral where the issuer's credit quality is deteriorating, posing a risk to the UCITS.

In order to address their concerns, the Central Bank has implemented the derogation with a requirement that:

- issuers subject to a credit rating by an agency registered and supervised by ESMA must have that rating taken into account by the responsible person in its credit assessment process; and
- where an issuer (as described in the paragraph above) is downgraded below the two highest short term credit ratings of the relevant credit agency, a new credit assessment must be carried out without delay.

F. OTC derivative valuations

UCITS valuation provisions were previously governed by the UCITS Notices, Guidance Note 1/00 and also by a chart in the UCITS Section 2 Application Form. In those provisions, OTC derivatives were to be valued either on the basis of the counterparty valuation as independently verified or an alternative valuation provided by a competent person, firm or association appointed by the directors and approved by the depositary.

The Central Bank has now included in the Regulations updated procedures for the valuation of UCITS' assets which remove this requirement for the valuation of OTC derivatives. This corresponds to the requirement in Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) that "financial counterparties and non-financial counterparties [referred to in Article 10 of 648/2012] shall mark-to-market on a daily basis the value of outstanding contracts. Where market conditions prevent marking-to-market, reliable and prudent marking-to- model shall be used." This requirement is further supplemented by Article 16 of Commission Delegated Regulation 149/2013 which discusses what the market conditions that may be considered as preventing marking to market.

It should be noted that this means of valuation is not required to be implemented for existing UCITS where their valuation rules are contained in a prospectus already approved by the Central Bank. In addition, new UCITS may have alternative valuation procedures approved by the Central Bank.

G. Depositary notification of non-material breaches

Irish UCITS have always had an added layer of oversight above the UCITS requirements with the "trustee duties" which involve a set of fiduciary oversight duties by the depositary. The most recent duty, which was implemented several years ago, was to notify the Central Bank promptly of any material breach of the Directive Regulations, the conditions imposed by the Central Bank or the prospectus.

The Regulations have extended this duty further to require that the depositary shall notify the Central Bank promptly of any non-material breach of the Directive Regulations, the conditions imposed by the Central Bank on the UCITS or the prospectus where the breach is not resolved within four weeks of the depositary becoming aware of that breach.

Remedying non-material breaches, e.g. an inadvertent breach of issuer concentration limits, taking due account of the interests of unitholders is a priority as opposed to an immediate objective. However, this new deadline of reporting breaches, while not prohibiting a good argument for maintaining an open non-material breach, brings a further impetus to swift rectification.

H. Gating

Irish UCITS are permitted to apply redemption gates where total requests for redemption on any dealing day exceed 10% of the net assets of the UCITS or sub-fund as applicable. Previously, it was the case that many UCITS applied a provision that where a gate was implemented, the redemptions would be conducted pro rata on each subsequent dealing day until the redemption request was fulfilled with redemptions submitted from an earlier dealing day would rank in priority against requests from later dealing days.

The Central Bank has now clarified that it is not, in their view, equitable for shareholder requests from earlier dealing days to have priority against requests from later dealing days and UCITS with this provision will need to amend their prospectus where this is included in line with the transition dates detailed below.

I. Non-EEA Foreign Registrations

As a global brand, UCITS are being sold beyond their initially staked territory of the EEA and the Central Bank is keen to have more detailed information on where Irish UCITS are being sold for statistical purposes.

Accordingly, the Regulations now require the responsible person to notify the Central Bank promptly where the UCITS is registered for sale (or de-registered for sale in the future) in a non-EEA jurisdiction.

J. Second Half-Year Accounts for Management Companies and Depositaries

UCITS management companies and depositaries have previously been required to provide accounts for the first six months of the year and then annual financial statements. However, the Central Bank now requires a separate set of accounts relating only to the second six months of the year to be filed along with the previously required first half-yearly and annual accounts.

In the view of the Central Bank, the benefit to having this additional set of accounts is to allow better comparisons between the first six months and the second six months of the year when reviewing accounts for these entities.

This does not apply to self-managed entities.

Making the Switch – Transition timetable

The Regulations officially came into force on 1 November 2015. Existing UCITS (authorised prior to 1 November 2015) are required to comply with the Regulations by 1 November 2016.

The Central Bank has highlighted, however, that if a UCITS wishes to take advantage of new flexibilities (e.g. in relation to collateral) these matters must be implemented into its prospectus prior to utilisation.

There are other specific transitional matters for existing UCITS apart from the general provisions above which should be noted:

- The requirements in relation to the long/short disclosures are to be included at the next update of the prospectus regardless of any other timelines. As such, the new updates of Irish UCITS prospectuses for UCITS V will likely be the next update for most Irish UCITS and this requirement will need to be included at that point.

- The requirements for second half year accounts for management companies and depositaries begin on the financial year commencing after the implementation of the Regulations.

- Provisions relating to the operation of management companies (which are also applicable to self-managed entities) regarding the implementation of the new managerial functions and requirements and the implementation of the organisational effectiveness role as outlined in the Central Bank's feedback paper on CP 86 (Consultation on Fund Management Company Effectiveness- Delegate Oversight) must be implemented by 30 June 2016.

Should We Expect Any More Changes Soon? – Upcoming Changes to the Regulations

It is expected that the Regulations will be updated in the near future to address the changes of UCITS V.

The Extra Bits - Miscellaneous Provisions

A. Goodbye Derogations, Hello Waivers!

Previously, the Central Bank would grant derogations from provisions of the UCITS Notices on a case by case basis. Derogations are now called waivers and they are not automatically carried forward; an application must be made for a new "waiver". The requirement does not apply to derogations permitted under the Directive Regulations e.g. compliance with diversification limits for the first 6 months after launch.

The granting of a waiver should not be assumed in the absence of a compelling reason.

B. Typos

The Central Bank has highlighted a few typographical errors that will be amended the next time the Regulations are amended. These are:

- At Regulation 9 (12), the reference to 75 per cent is incorrect and should refer to "sub-categories of the same commodity are highly correlated if 25 per cent of the correlation observations are above 0.8".
- At Regulation 124 (3) which refers to Regulation 97(1) (c) but should refer to 97(1) (a).
- At Schedule 3, Paragraph 5 (i) where it states "subject to subparagraph (2iicollateral…", which should be "subject to subparagraph (ii) collateral…".

Conclusions

Overall the Regulations are largely, as expected, a consolidation and reformatting exercise. However, there are some elements that alter existing practice and which will have an impact on existing and new UCITS alike. Each existing UCITS should consider the Regulations and their impact with their legal advisers and take advantage of opportunities such as the document updates required for UCITS V to implement new flexibilities such as the collateral diversification provisions discussed above.

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