

A Guide to  
UCITS  
in Ireland

DILLON  EUSTACE

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## A GUIDE TO UCITS IN IRELAND

Undertakings for Collective Investment in Transferable Securities, commonly referred to as “**UCITS**”, are collective investment schemes established and authorised under a harmonised European Union (EU) legal framework under which a UCITS established and authorised in one EU Member State can be sold cross border into other EU Member States without a requirement for an additional authorisation. This so-called “European passport” is central to the UCITS product and enables fund promoters to create a single product for the entire EU rather than having to establish an investment fund product on a jurisdiction by jurisdiction basis.

Originally introduced over twenty five years ago, UCITS have become the gold standard EU investment fund product, recognised not only by the European financial services community but also further afield with many non-EU jurisdictions accepting UCITS as suitable for retail sale into their domestic markets. Whilst sold across the full spectrum of investor types, UCITS have been designed principally for the retail market as open-ended diversified, liquid products with their parameters - permitted asset classes and investment and borrowing restrictions - being enshrined in EU law.

UCITS is not a product which has stood still. It has continued to evolve, with a significant broadening of permitted asset classes and more robust governance requirements being introduced in 2002 and clarified in 2007. More recently, a series of additional changes have been implemented under the UCITS IV Directive in order to further simplify the European passport process for UCITS, introduce master/feeder type structures, create a framework for cross-border fund mergers, replace the simplified prospectus and introduce further measures in relation to the UCITS management company passport. Next year we will see the arrival of UCITS V, and a UCITS VI proposal document has already been circulated.

Underpinning UCITS, and the proposed future evolutions of the product, has been a common harmonised approach with involvement from securities regulators and industry participants across the European Union at each stage of the process. Whilst at times the pace of change may be too fast for some and too slow for others, to date UCITS has generally achieved the right balance.

Ireland has become one of the leading EU “exporting” jurisdictions for UCITS having been pro-active in implementing the UCITS regime into domestic legislation in 1989, introducing a sensible investment funds focused fiscal regime and clear but prudential process for the authorisation and supervision of UCITS and relevant service providers.

The result has been that promoters from all across the world have and continue to use Ireland as a domicile of choice for UCITS products seeking to access the European market place and, in many

cases, further afield. End 2014 figures from EFAMA indicate that the AuM of Irish domiciled UCITS exceed Euro 1.27 trillion.

Dillon Eustace has been and will continue to be in the vanguard of all these UCITS developments, playing a leadership role in UCITS evolution, domestically and internationally.

At the time of issuing this Guide we await UCITS V implementation, finalisation of the Central Bank's response to CP 86, as well as possible conceptual changes to the UCITS Notices. We do expect, therefore, to be updating this Guide both soon and regularly.

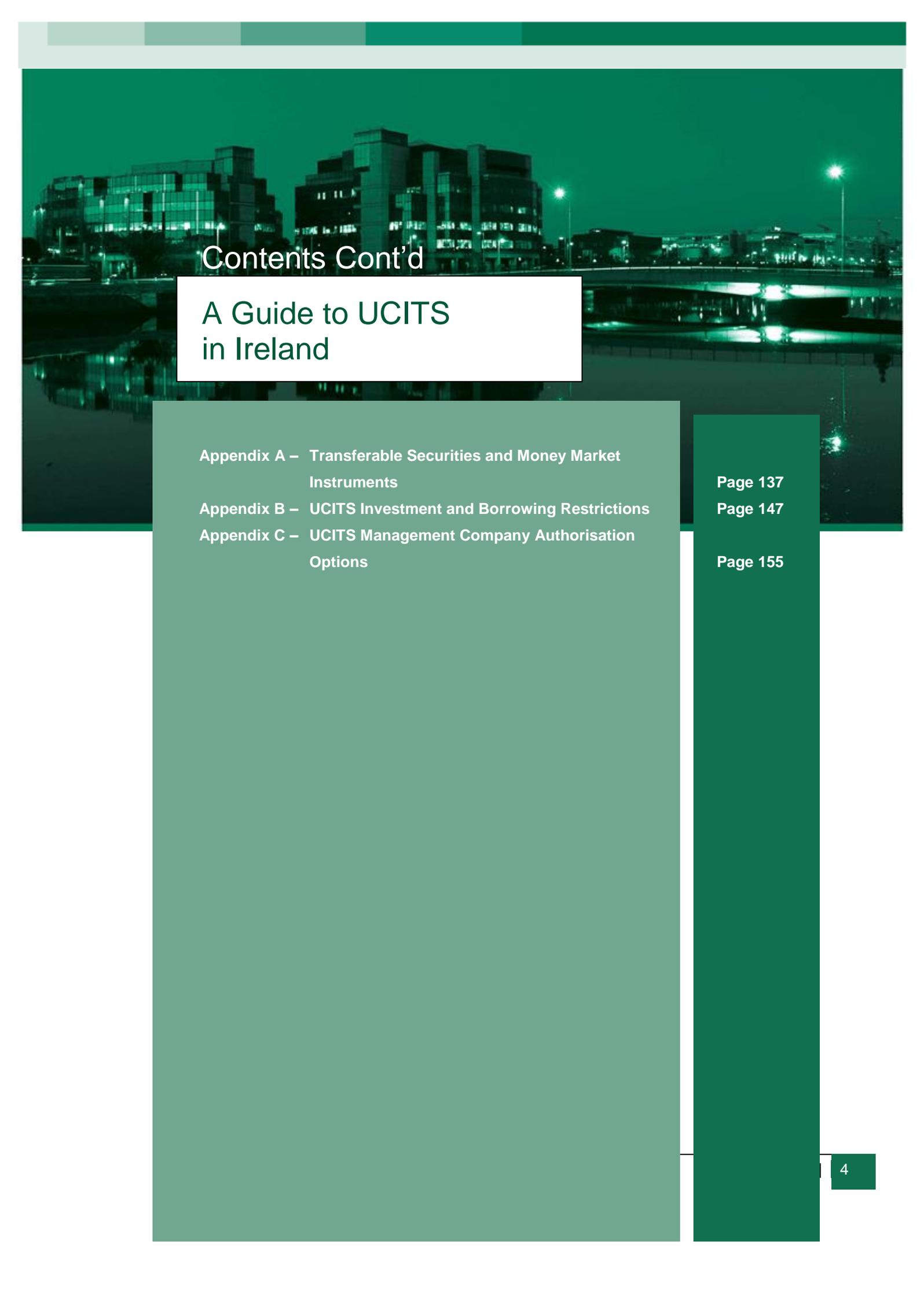
We hope that this Guide assists you. It is primarily designed to bring practical and regulatory and legislative provisions together in one document, mainly to make life a little easier.

**Dillon Eustace Asset Management Team**  
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## 1. Legislative Basis for UCITS in Ireland

The legislative basis for UCITS in Ireland is European law, implemented domestically and expanded upon by UCITS related notices (the “**UCITS Notices**”) issued by the Central Bank of Ireland (the “**Central Bank**”) and with further clarification provided for in a series of Central Bank guidance notes (“**Guidance Notes**”). Each element – European and domestic legislation and the UCITS Notices and Guidance Notes – has evolved and been amended over time.

### 1.1 European Legislation

The original UCITS Directive (Directive 85/611/EC) of 1985 established the UCITS product as a pan-European collective investment scheme which benefited from an EU-wide product passport based on the concept of mutual recognition of Home State authorisation, setting down the legal forms which UCITS could take, their permitted investment and borrowing rules, liquidity requirements, prospectus disclosure rules and rules relating to annual and semi-annual reporting as well as rules relating to the role and duties of UCITS custodians/depositaries and their management companies.

Whilst amended in 1988, 1995 and in 2000, no substantive change to the UCITS product was made until 2002, with the introduction of the UCITS Management Company Directive (Directive 2001/107/EC) and the UCITS Product Directive (Directive 2001/108/EC). The Management Company and Product Directives are referred to collectively as “**UCITS III**”. UCITS III represented a major overhaul of UCITS in terms of what they could invest in, how they could be offered and sold and how they were to be managed.

Given the experience of the original UCITS regime and an often inconsistent, as between EU Member States, application of its terms, the introduction of UCITS III was followed by the creation of CESR, the Committee of European Securities Regulators, (now known as the European Securities and Markets Authority (“**ESMA**”)), which was requested to advise on the interpretation of terms used within UCITS III with the aim of achieving a common agreed position on its interpretation and application. Following a series of consultations, CESR issued its final advices in January, 2006, followed in March, 2007 by a European Commission implementing Directive (Directive 2007/16/EC), referred to as the “**Eligible Assets Directive**”, which was in turn accompanied by CESR guidelines concerning UCITS eligible assets.

### 1.2 UCITS IV

In June 2009, Directive 2009/65/EC (the “**UCITS IV Directive**”) was adopted. The UCITS IV Directive repealed all prior UCITS Directives and successive amendments thereto (with the exception of the Eligible Assets Directive).

The UCITS IV Directive and its accompanying Level 2 measures are supplemented by a number of Level 3 measures, (together, “**UCITS IV**”), which are listed below.

(i) *Level 2 measures:*

- Commission Directive 2010/43/EU (organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company)
- Commission Directive 2010/44/EU (fund mergers, master-feeder structures and notification procedure)
- Commission Regulation (EU) No 583/2010 (key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website)
- Commission Regulation (EU) No 584/2010 (form and content of the standard notification letter and UCITS attestation, the use of electronic communication between competent authorities for the purpose of notification, and procedures for on-the-spot verifications and investigations and the exchange of information between competent authorities)

(ii) *Level 3 measures:*

- ESMA’s Guidelines on a common definition of European money market funds (ref: CESR/10-049)
- ESMA’s Guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document (ref: CESR/10-673)
- ESMA’s Guidelines on the methodology for calculation of the ongoing charges figure in the Key Investor Information Document (ref: CESR/10-674)
- ESMA’s Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (ref: CESR/10-788)
- Selection and presentation of performance scenarios in the Key Investor Information document (KII) for structured UCITS (ref: CESR/10-1318)

- Transition from the Simplified Prospectus to the Key Investor Information document (ref: CESR/10-1319)
- ESMA's guide to clear language and layout for the Key Investor Information document (ref: CESR/10-1320)
- ESMA's template for the Key Investor Information document (ref: CESR/10-1321)
- ESMA's Guidelines on ETFs and other UCITS issues (including new requirements in relation to index-tracking UCITS, UCITS ETFs, efficient portfolio management techniques, financial derivative instruments, collateral requirements and financial indices)
- ESMA "Questions and Answers" paper in relation to its "Guidelines on ETFs and other UCITS issues".

### 1.3 UCITS V

Adopted on September 17, 2014, the most recent piece of UCITS legislation is Directive 2014/91/EU ("**UCITS V**") which EU Member States are required to transpose into their national laws by March 18, 2016. The principal aim of UCITS V is to increase the level of protection employed by UCITS investors by introducing new requirements in relation to remuneration, regulatory sanctions and depositaries.

Further detail in relation to UCITS V is set out in Chapter 21.

### 1.4 Irish Legislation

The 1985 UCITS Directive (as amended) was implemented into domestic Irish law by the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 1989 (the "**1989 UCITS Regulations**").

The 1989 UCITS Regulations were amended in 1996, 1999 and in 2003 and were then revoked and replaced, in the context of domestic Irish implementation of UCITS III, by the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations (S.I. No. 212/2003) (as amended by S.I. No. 213 of 2003) (the "**2003 UCITS Regulations**").

The 2003 Regulations were subsequently amended by S.I. No. 497/2003, by the Central Bank and Financial Services Authority Act, 2004 (introduction of a single regulator for financial services in

Ireland), by the Investment Funds, Companies and Miscellaneous Provisions Act, 2005 (introduction of segregated liability for umbrella investment companies) and by S.I. No. 832/2007 (implementation of the Eligible Assets Directive).

On June 29, 2011, the Irish Minister for Finance signed into law the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011 (which we refer to in this Guide as the “**UCITS Regulations**”), which transpose the UCITS IV Directive into Irish law and consolidate all prior UCITS legislation.

New legislation will be required to be adopted in Ireland by March 18, 2016 in order to transpose UCITS V into Irish law.

## 1.5 UCITS Notices

The Central Bank has issued a specific set of UCITS Notices which explain and clarify various aspects of the UCITS Regulations and which set down conditions not contained within the UCITS Regulations with which Irish UCITS are required to conform. The power to set down such conditions is found in Regulation 123 of the UCITS Regulations.

Revised UCITS Notices and Guidance Notes to reflect UCITS IV were issued in conjunction with the signing of the 2011 UCITS Regulations, completing the regulatory regime for UCITS IV in Ireland, and they have been subsequently updated to reflect various matters, including ESMA’s “Guidelines on ETFs and other UCITS issues”.

The UCITS Notices deal with:

- Information and document requirements of the Central Bank in support of an application for authorisation as a UCITS – UCITS 1.
- Supervisory and reporting requirements and conditions for UCITS management companies, UCITS self-managed investment companies and administration companies authorised by the Central Bank – UCITS 2.
- Trustees – eligibility criteria – UCITS 3.
- Trustees – duties, supervisory and reporting requirements and conditions – UCITS 4.
- Supervisory and reporting requirements and conditions for UCITS authorised by the Central Bank of Ireland – UCITS 5.

- Prospectus – UCITS 6.
- Information to be included in the monthly returns – UCITS 7.
- Publication of annual and half-yearly reports – UCITS 8.
- Eligible assets and investment restrictions – UCITS 9.
- Financial derivative instruments – UCITS 10.
- Borrowing powers – UCITS 11.
- Techniques and instruments including Repurchase/Reverse Repurchase Agreements and Securities Lending, for the purposes of efficient portfolio management – UCITS 12.
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- Dealings by promoter, manager, trustee, investment adviser and group companies – UCITS 14.
- Cross – border notification of UCITS – UCITS 15.
- Code of conduct in relation to collective portfolio management – UCITS 16.
- Money Market Funds – UCITS 17.
- Master-Feed Structures – UCITS 18.
- Key Investor Information Document – UCITS 19.
- Exchange Traded Funds – UCITS 20.
- Financial Indices – UCITS 21.
- Capital compliance requirement - guidance and regulatory report – Annex I.
- Requirements on outsourcing of administration activities in relation to CIS – Annex II.

Detail from specific UCITS Notices is provided throughout this Guide.

## 1.6 Central Bank Guidance Notes, Policy Documents and Q&A

The Central Bank has also issued a series of Guidance Notes to provide further clarification on its approach on particular issues. It has also issued a number of specific policy documents of relevance to UCITS.

Certain Guidance Notes deal with UCITS promoters, permitted markets for retail schemes, multi-adviser schemes, Money Market Funds, valuation rules, etc., while others deal with UCITS investing in other collective investment schemes, UCITS investing in Financial Derivative Instruments, the Key Investor Information Document, UCITS investing in Financial Indices and UCITS prospectus disclosures for Structured Products and Complex Trading Strategies.

Originally certain of those Guidance Notes applied not only to UCITS but also to regulate Irish Non-UCITS schemes. Although the references to Irish Non-UCITS schemes remain in places, those Guidance Notes no longer apply to Non-UCITS as they are now dealt with by the Central Bank's AIF Rulebook.

Most recently, the Central Bank has commenced the practice of issuing and updating a UCITS Q&A document, available on its website, dealing with commonly asked queries.

## 1.7 Central Bank UCITS Regulations

As of the date of issuing this Guide, our understanding is that the Central Bank proposes to replace its current UCITS Notices and Guidance Notes with a set of Central Bank UCITS Regulations to be issued by it pursuant to Section 48(1) of the Central Bank (Supervision and Enforcement) Act, 2013 (the "**2013 Act**"). Previously, as part of its Consultation Paper 77, it had indicated that it was going to replace the UCITS Notices and Guidance Notes with a UCITS Rulebook, similar in broad design to the AIF Rulebook which it has issued in relation to regulated Irish domiciled alternative investment funds.

We do not have any further update on this proposal and would intend updating this Guide if and when such Regulations issue.

## 2. Overview of UCITS Permitted Asset Classes and Investment and Borrowing Restrictions

Core features of the UCITS product since 1985 have included the imposition of restrictions on the types of assets that a UCITS can invest in, the imposition of a variety of portfolio concentration rules and the imposition of restrictions on borrowings. The original 1985 limits were altered by UCITS III and further changes were introduced by both Eligible Assets Directive and by UCITS IV.

However, reflecting that, UCITS are products designed with the retail investor in mind, product rules remain and, if anything, are being tightened over time.

### 2.1 Permitted Asset Classes

Although dealt with in greater detail in the following Chapters, UCITS are in summary permitted to invest in:

- (i) transferable securities and money market instruments which are either admitted to official listing on a stock exchange in an EU Member State or non-EU Member State or which are dealt on a market which is regulated, operating regularly, recognised and open to the public;
- (ii) recently issued transferable securities which will be admitted to official listing on a stock exchange or other market (as described above) within a year;
- (iii) money market instruments (other than those dealt in on a regulated market) provided that the issue or the issuer is itself regulated for the purpose of protecting investors and savings;
- (iv) units of UCITS and units of non-UCITS collective investment schemes (CIS) (in certain cases);
- (v) deposits with credit institutions;
- (vi) financial derivative instruments that meet certain criteria; and
- (vii) transferable securities and money market instruments other than those referred to above (subject to a maximum aggregate limit of net asset value).

Given the increased investment opportunities granted under UCITS III and the subsequent clarification of the terms “*transferable securities*” and “*money market instruments*” in the Eligible Assets Directive, UCITS provide for a broad spectrum of fund types and exposures, from relatively

plain vanilla equity and bond products through to long/short and absolute return type UCITS and other seeking to follow more alternative type strategies, with UCITS fund of funds, master/feeders, money market and cash funds as well as UCITS ETFs and other index replicators also being catered for.

## 2.2 Investment and Borrowing Restrictions

The standard UCITS investment and borrowing restrictions are set out in Appendix B to this Guide.

In the following Chapters further detail is given with regard to the application of those investment and borrowing restrictions, taking account of how the Central Bank has interpreted and/or applies those restrictions in the context of particular types of UCITS products.

In summary, however, it is important to note that:

- (i) the principal UCITS focus is on portfolio diversification and liquidity;
- (ii) no more than 10% of a UCITS net assets may be invested in transferable securities or money market instruments issued by the same body, with a further aggregate limitation of 40% of net assets on exposures of greater than 5% to single issuers (otherwise known as the “**5/10/40**” rule);
- (iii) there are exceptions to the above for investments issued or guaranteed by governments, local authorities or certain public international or supra-national bodies;
- (iv) index replicators can take exposures up to 20% of net assets to single issuers, with up to 35% to a single issuer in exceptional market conditions;
- (v) up to 100% of net assets can be invested in other collective investment schemes (“**CIS**”), provided no more than 20% invested in any one CIS, with an aggregate restriction of 30% of net assets applying to investment in non-UCITS CIS as well as strict rules applying to the nature of CIS in which a UCITS can invest, as well as limiting investment to a maximum of 25% of the units of the underlying CIS.

**NOTE:** Since the Central Bank’s adoption of ESMA’s Opinion on the interpretation of Article 50(2)(a) of the UCITS Directive, all open-ended ETFs will be treated, exclusively, as CIS for UCITS investment eligibility purposes. They may not be treated as transferable securities. They are not automatically eligible for UCITS investment and need to be examined for eligibility on a case by case basis;

- (vi) master-feeder structures have been permitted since UCITS IV and, accordingly, UCITS may invest (by way of derogation from the limits above) at least 85% of its assets in the units of another UCITS – see further the Chapter 8 relating to Master / Feeder UCITS;
- (vii) no more than 20% of net assets can be invested in cash deposits with any one credit institution as permitted by the Central Bank and up to 10% of net assets may be held for ancillary liquidity purposes with other credit institutions (which 10% limit is raised to 20% in the case of deposits made with the custodian/trustee);
- (viii) investments in/through derivatives may be made/taken to assets in which a UCITS can invest directly (including financial instruments having one or several characteristics of those assets), as well as where the underlying exposure is to financial indices, interest rates, FX rates or currencies;
- (ix) the maximum exposure to a single OTC derivative counterparty is 5%, increasing to 10% for certain credit institutions. The risk exposure to a counterparty arising from OTC derivative transactions and efficient portfolio management techniques must be combined when calculating these limits;
- (x) various aggregations of the above restrictions apply (see Appendix B for further detail);
- (xi) the maximum aggregate exposure to transferable securities/money market instruments not listed or traded on a regulated market is 10% of net assets;
- (xii) additional general provisions apply including concentration limits, prohibitions on taking legal/management control of issuers, prohibitions on uncovered sales; and
- (xiii) borrowings are limited to 10% of net assets and can only be used for temporary purposes (for liquidity).

### 2.3 Efficient Portfolio Management Techniques and Instruments

UCITS are permitted to use techniques and instruments relating to transferable securities and money market instruments for efficient portfolio management (“EPM”) purposes, which is taken to mean that they must be economically appropriate and be entered into with the aim of reducing risk, reducing cost or generating additional capital or income (with a level of risk consistent with the UCITS risk profile).

Derivatives used for EPM purposes must comply with normal rules for investment in financial derivative instruments.

Repos/Reverse Repos and stocklending are also expressly permitted, with strict rules regarding collateral including acceptable forms of collateral, the level of collateral provided, diversification of collateral, valuation of collateral and how and where it is held and maintained.

There are also strict rules as to counterparty credit rating (A2 or equivalent or deemed implied rating of A2) or indemnification.

### 3. Transferable Securities and Money Market Instruments

As the UCITS acronym suggests, UCITS original focus was on investment in “transferable securities” (as well as “money market instruments”) although it now offers far wider investment possibilities, as explained below.

Although the definitions of both “transferable securities” and “money market instruments” are set out in it Appendix A, we have highlighted the key elements of both below, particularly given the clarifications provided in 2007 by the Eligible Assets Directive.

#### 3.1 Transferable Securities

(i) *UCITS Directive definitions*

The term “transferable securities” is defined as follows:

- (a) shares in companies and other securities equivalent to shares in companies (“*shares*”);
- (b) bonds and other forms of securitised debt (“*debt securities*”);
- (c) other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange;

other than the permitted UCITS efficient portfolio management (EPM) techniques and instruments.

(ii) *Clarification by Eligible Asset Directive*

In 2007, the Eligible Assets Directive clarified the above definition by providing that the reference to transferable securities “*shall be understood as a reference to financial instruments which fulfill the following criteria*”:

- (a) the potential loss which the UCITS may incur with respect to holding those instruments is limited to the amount paid for them;
- (b) their liquidity does not compromise the ability of the UCITS to comply with its obligation to provide at least fortnightly redemption facilities;
- (c) reliable valuation is available for them, as follows:

- (i) in the case of securities admitted to or dealt in on a regulated market in the form of accurate, reliable and regular prices which are either market prices or prices made available by valuation systems independent from issuers;
  - (ii) in the case of other securities (i.e. the aggregate 10% that can be invested in transferable securities and money market instruments not specifically referred to in Article 50(1)), in the form of a valuation on a periodic basis which is derived from information from the issuer of the security or from competent investment research;
- (d) appropriate information is available for them, as follows:
- (i) in the case of securities admitted to or dealt in on a regulated market as referred to in subparagraphs (a) to (d) of Article 50(1), in the form of regular, accurate and comprehensive information to the market on the security or, where relevant, on the portfolio of the security;
  - (ii) in the case of other securities as referred to in Article 50(2), in the form of regular and accurate information to the UCITS on the security or, where relevant, on the portfolio of the security;
- (e) they are negotiable;
- (f) their acquisition is consistent with the investment objectives or the investment policy, or both, of the UCITS;
- (g) their risks are adequately captured by the risk management process of the UCITS.

It is worth emphasising that liquidity is a central requirement for UCITS portfolios and that, accordingly, broad principles are laid down regarding presumptions as to liquidity, assessment of liquidity risk where information is available which suggests redemption facilities could be compromised by a transferable security, as well as principles regarding consideration of or presumption of negotiability.

*(iii) Closed Ended Funds*

The Eligible Assets Directive also made it clear that certain closed-ended funds would fall within the “transferable securities” definition and, therefore, be eligible for investment by UCITS as “transferable securities” where:

- (a) they fulfill the criteria set out in “*(ii) Clarification by Eligible Assets Directive*” above;

- (b) they are subject to corporate governance mechanisms applied to companies or equivalent to those applied to companies;
- (c) they are managed by an entity which is (or where asset management activity is carried out by another entity on behalf of the closed ended fund, that entity is) subject to national regulation for the purpose of investor protection.

Appendix A sets out some of the principles used in considering the equivalence of corporate governance mechanisms for contractual type closed-ended funds.

**NOTE:** it is expressly provided that a UCITS may not make investment in closed ended funds for the purposes of circumventing the normal UCITS investment limits.

(iv) *Structured Financial Instruments*

Structured financial instruments may also be eligible for investment as “transferable securities” where they are financial instruments which:

- (a) fulfill the criteria set out “(ii) *Clarification by Eligible Assets Directive*” above;
- (b) are backed by, or linked to the performance of, other assets, which may differ from those referred to in Regulation 68 (1) of the UCITS Regulations; provided that where a financial instrument covered by this subparagraph contains an embedded derivative component, the requirements regarding the derivatives risk management process, global exposure and aggregation of direct and indirect exposures shall apply to that component.

## 3.2 Money Market Instruments

The term “money market instruments” refers to instruments normally dealt in on the money market which are liquid, and have a value which can be accurately determined at any time. UCITS can invest in money market instruments admitted to trading/dealt in on a regulated market and in money market instruments which are not admitted to or dealt in on a regulated market.

(i) *Instruments normally dealt in on the Money Market*

The reference to money market instruments as “*instruments normally dealt in on the money market*” shall be understood as a reference to financial instruments which fulfil one of the following criteria:

- (a) they have a maturity at issuance of up to and including 397 days;

- (b) they have a residual maturity of up to and including 397 days;
- (c) they undergo regular yield adjustments in line with money market conditions at least every 397 days;
- (d) their risk profile, including credit and interest rate risks, corresponds to that of financial instruments which have a maturity as referred to in subparagraphs (i) or (ii), or are subject to a yield adjustment as referred to in subparagraph (iii).

(ii) *Instruments which are liquid*

The reference to money market instruments as “instruments which are liquid” shall be understood as a reference to financial instruments which can be sold at limited cost in an adequately short time frame, taking into account the obligation of the UCITS to repurchase or redeem its units at the request of any unit holder.

Appendix A to this Guide sets down the factors to be taken into account at both the instrument and fund level in assessing liquidity.

(iii) *Instruments which have a value which can be accurately determined at any time*

The reference to “money market instruments as instruments which have a value which can be accurately determined at any time” shall be understood as a reference to financial instruments for which accurate and reliable valuations systems, which fulfil the following criteria, are available:

- (a) they enable the UCITS to calculate a net asset value in accordance with the value at which the financial instrument held in the portfolio could be exchanged between knowledgeable willing parties in an arm’s length transaction;
- (b) they are based either on market data or on valuation models including systems based on amortised costs.

With respect to the criterion “value which can be accurately determined at any time”, if the UCITS considers that an amortisation method can be used to assess the value of a money market instrument, it must ensure that this will not result in a material discrepancy between the value of the money market instrument and the value calculated according to the amortisation method as set out in UCITS Notice I7 – Money Market Funds.

More detail on liquidity requirements and on governmental issues and on issues by securitisation vehicles can be found in Appendix A.



## 4. UCITS Money Market Funds

Whilst many UCITS will invest principally in money market instruments and may consider themselves to be money market funds, only certain funds are permitted by the Central Bank to refer to “*money market fund*” in their name.

Previously, the only UCITS permitted to use the term “money market fund” in their title and follow an amortised cost valuation methodology were:

- UCITS established as constant NAV Funds; or
- UCITS accumulating NAV funds, with the principal objective to preserve principal and maintain liquidity and which obtained a triple A rating from an internationally recognised rating agency together with a supplementary market risk rating (or which had management companies / investment managers with demonstrable expertise in the operation of money market funds, which used amortised cost valuation) were.

### 4.1 Types of Money Market Funds

The Central Bank now distinguishes between “*Short-Term Money Market Funds*” and “*Money Market Funds*”. Its UCITS Notice 17 sets out the rules upon which a UCITS may label itself or market itself as a money market fund. Under those rules, a UCITS money market fund must classify itself as either a “Short-Term Money Market Fund” or as a “Money Market Fund”.

*Short-Term Money Market Funds* may have either a constant or fluctuating NAV and are permitted to follow an amortised cost valuation methodology, as further set out below.

*Money Market Funds* must have a fluctuating NAV and are not permitted to follow an amortised cost valuation methodology.

A number of conditions apply to Short-Term Money Market Funds and Money Market Funds as set out below. Where we just use “money market fund”, we are referring to both “Short-Term Money Market Funds” and “Money Market Funds”. Otherwise, we distinguish between the two.

### 4.2 Disclosure Requirements

A UCITS money market fund must indicate in its prospectus whether it is a *Short-Term Money Market Fund* or a *Money Market Fund*. It must also include a risk warning drawing attention to the difference between the nature of a deposit and the nature of an investment in a money market fund

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with particular reference to the risk that the principal investment in a money market fund is capable of fluctuation.

A UCITS money market fund must also provide appropriate information to investors on the risk and reward profile of the fund so as to enable investors identify any specific risks linked to the investment strategy of the money market fund. In the case of a UCITS classified as a Money Market Fund, this must take into account the longer WAM and WAL (see further below).

In the case of all UCITS money market funds, the information provided must take account, where relevant, investment in new asset classes, financial instruments or investment strategies with unusual risk and reward profiles.

### 4.3 Investment Objective

The primary investment objective of a UCITS money market fund structured either as a Short-Term Money Market Fund or as a Money Market Fund must be to maintain the principal of the fund and to aim to provide a return in line with money market rates.

### 4.4 Eligible Assets

The following conditions apply to both types of UCITS money market funds:

- (i) investments must be limited to “high quality” money market instruments which comply with the criteria for money market instruments as set out in the UCITS Regulations and deposits with credit institutions;
- (ii) direct or indirect exposure to equities or commodities, including through financial derivative instruments, is not permitted;
- (iii) financial derivative instruments which give exposure to foreign exchange may only be used for hedging purposes and investment in non-base currencies is not permitted unless the exposure is fully hedged; and
- (iv) investment in other collective investment schemes is not permitted unless the underlying scheme satisfies the following: (a) if the investing fund is a Short-Term Money Market Fund, the underlying scheme must be structured as a Short-Term Money Market Fund (b) if the investing fund is a Money Market Fund, the underlying scheme must be structured as either a Short-Term Money Market Fund or a Money Market Fund.

## 4.5 Daily NAV and Dealing

Both Short-Term Money Market Funds and Money Market Funds must provide daily NAV and price calculations. They must also both provide daily subscription and redemption of units/shares.

## 4.6 Residual Maturity

Investments are limited to securities or instruments with a residual maturity until the legal redemption date of less than or equal to 397 days, in the case of Short-Term Money Market Funds, and 2 years (provided that the time remaining until the next interest reset date is less than or equal to 397 days), in the case of Money Market Funds.

## 4.7 Weighted Average Maturity (“WAM”)

The WAM of the portfolio of a Short-Term Money Market Fund must not exceed 60 days, whereas the WAM of the portfolio of a Money Market Fund must not exceed 6 months.

## 4.8 Weighted Average Life (“WAL”)

The WAL of the portfolio must not exceed 120 days, in the case of a Short-Term Money Market Fund, or 12 months, in the case of a Money Market Fund.

In either case, when calculating the WAL for securities, the UCITS must base the maturity calculation on the residual maturity until the legal redemption of the instruments. However, when a financial instrument embeds a put option, the exercise date of the put option may be used instead of the legal residual maturity only if the following conditions are fulfilled at all times: (i) the put option can be freely exercised by the UCITS at its exercise date, (ii) the strike price of the put option remains close to the expected value of the instrument at the next exercise date; and (iii) the investment strategy of the UCITS implies that there is a high probability that the option will be exercised at the next exercise date.

When calculating the WAM and WAL, the impact of financial derivative instruments, deposits and efficient portfolio management techniques must be taken into account.

## 4.9 Short-Term Money Market Funds – Valuation on the basis of amortised cost

Valuation on the basis of amortised cost is permitted in the case of Short-Term Money Market Funds, subject to the following conditions:

(i) *Expertise*

Short-Term Money Market Funds are permitted to follow an amortised cost valuation methodology provided the UCITS or, where relevant, its delegate have demonstrable expertise in the operations of money market funds which follow this method of valuation.

This condition is satisfied where:

- (a) the Short-Term Money Market Fund has obtained a triple-A rating from an internationally recognised rating agency; or
- (b) the management company or investment manager is engaged in the management, or has been engaged in the management, of a triple-A rated money market fund; or
- (c) in exceptional circumstances, where the management company or investment manager has provided sufficient information to the Central Bank to demonstrate appropriate expertise in the operation of this type of money market fund.

The UCITS must be satisfied that the persons responsible for the operation of the Short-Term Money Market Fund, including under any delegation arrangements, have and continue to have the necessary expertise.

(ii) *Weekly review of discrepancies*

A UCITS Short - Term Money Market Fund must carry out a weekly review of discrepancies between the market value and the amortised cost value of its money market instruments. Escalation procedures must be in place to ensure that material discrepancies between the market value and the amortised cost value of a money market instrument are brought to the attention of the relevant personnel charged with the investment management of the UCITS.

If discrepancies in excess of 0.3% between the market value and the amortised cost value of the portfolio occur, a daily review must take place. In such circumstances, the UCITS must also notify the Central Bank with an indication of the action, if any, which will be taken to reduce such dilution.

The trust deed, deed of constitution, articles of association or instrument of incorporation of the UCITS must either provide for the escalation procedures set out above or provide that a review of the amortised cost valuation vis-à-vis market valuation will be carried out in accordance with the

requirements of the Central Bank. Weekly reviews and any engagement of escalation procedures must be clearly documented.

*(iii) Monthly Stress Testing*

The UCITS must engage in monthly portfolio analysis incorporating stress testing to examine portfolio returns under various market scenarios to determine if the portfolio constituents are appropriate to meet pre-determined levels of credit risk, interest rate risk, market risk and investor redemptions. The results of the periodic analysis must be available to the Central Bank on request.



## 5. Index Tracking UCITS

One of the cornerstones of the UCITS product since 1985 has been the imposition of portfolio diversification requirements under what is commonly known as the “5/10/40” rule. That rule provides that a UCITS may invest no more than 10% of its net assets in transferable securities or money market instruments issued by the same body, subject to the further proviso that the total value of transferable securities or money market instruments held in issuing bodies in each of which it can invest more than 5% is less than 40%.

That created problems for UCITS which wished to track an index where the weighting of a constituent element of the index breached the 5/10/40 rule or where the relationship between two or more constituent elements of the index meant that they were considered to constitute a single issuer, resulting in an aggregation of the exposure. That was addressed in most part by UCITS III.

It should, however, also be noted that in its “*Guidelines on ETFs and Other UCITS Issues*” ESMA has introduced a series of additional requirements relating to “financial indices”. Those rules apply not only where such indices are the underlyings of derivatives but also where UCITS seek to utilise the 20%/35% rule, explained further below, to track or replicate an index. (See also Chapter 9).

### 5.1 20% and 35% Rule

Since UCITS III, a UCITS whose policy is to replicate an index is permitted to invest up to 20% of its net assets in shares and/or debt securities issued by the same body, with the 20% limit being raised up to 35% in the case of a single issuer where justified by exceptional market conditions. This flexibility is permitted where the relevant index is recognised by the Central Bank on the basis that it is *sufficiently diversified*, it represents an *adequate benchmark* for the market to which it refers and it is *published in an appropriate manner*.

### 5.2 Index Criteria

Readers should note the applicable index criteria rules set out in Chapter 9 which have been laid down by ESMA. These relate to *single commodity indices; adequate benchmark; bespoke indices; rebalancing frequency; calculation methodology; predetermined rules / objective criteria; publication of constituents and weightings; and, independent valuation*.

Index due diligence requirement also apply.

### 5.3 Index Replication

The reference to “*replication*” of the composition of a shares or debt securities index is considered by the Central Bank to mean replication of the composition of the underlying assets of the index, including the use of derivatives or other permitted UCITS efficient portfolio management techniques and instruments.

### 5.4 Sufficient Diversification

Although somewhat circular, reference to an index’s composition being *diversified* refers to an index which allows for a maximum weighting per issuer of 20% with a capacity for a single constituent to exceed 20% but not exceed 35% of the index.

### 5.5 Adequate Benchmark

The reference to the index representing an *adequate benchmark* for the market to which it refers is a reference to an index whose provider uses a recognised methodology which generally does not result in the exclusion of a major issuer of the market to which it refers.

### 5.6 Publication

That the index *be published in an appropriate manner* refers to an index which is accessible to the public and where the index provider is independent from the index replicating UCITS. Note, however, that this second requirement does not preclude index providers and the UCITS forming part of the same economic group, provided that effective arrangements for the management of conflicts of interest are in place.

### 5.7 Disclosure Requirements

Where a UCITS intends to make use of the increased 20%/35% diversification limits, that must be disclosed clearly in the prospectus, together with a description of the exceptional market conditions which justify such investment. ESMA’s “*Guidelines on ETFs and other UCITS issues*”, as reflected in the UCITS Notices, also require that a UCITS which replicates a stock or debt securities index (including UCITS ETFs) include a prominent statement to this effect in the prospectus and any other promotional literature.

In addition, the prospectus of an index-tracking UCITS is required to include:

- (i) a clear description of the index, including information on the underlying components or details of the website where the exact composition of the index is published;
- (ii) information on how the index will be tracked (for example, whether it will follow a full or sample based physical replication model or a synthetic replication) and the implications of the chosen method for investors in terms of their exposure to the underlying index and counterparty risk (this information should also be included in summary form in the Key Investor Information Document);
- (iii) information on the anticipated level of tracking error in normal market conditions; and
- (iv) a description of factors that are likely to affect the ability of the UCITS to track the performance of the index, such as transaction costs, small illiquid components or dividend re-investments.

In the case of an index-tracking *leveraged* UCITS, the prospectus should also include the following information:

- (v) a description of the leverage policy, how this is achieved (i.e. whether the leverage is at the level of the index or arises from the way in which the UCITS obtains exposure to the index), the cost of the leverage (where relevant) and the risks associated with this policy;
- (vi) a description of the impact of any reverse leverage (i.e. short exposure);
- (vii) a description of how the performance of the UCITS may differ significantly from the multiple of the index performance over the medium to the long term.

That information should also be disclosed, in summary, form in the Key Investor Information Document.

## 5.8 Annual and Half-Yearly Reports

The annual and half-yearly reports of an index-tracking UCITS must disclose the size of the tracking error at the end of the period under review.

The annual report should also provide an explanation of any divergence between the anticipated and realised tracking error for the relevant period and should also disclose and explain the annual tracking difference between the performance of the UCITS and the performance of the index tracked.



## 6. UCITS ETFs

An exchange traded fund (“**ETF**”) is a type of investment fund structured to facilitate trading of its shares on an exchange. ETFs generally function as index tracking funds (i.e. they provide their investors with an exposure to the securities in an index) and the exchange listing means that the ETF shares can be bought and sold by investors on an intra-day basis and using real-time pricing, much like an equity security. In essence, an ETF offers characteristics of an investment fund (such as low costs and broad diversification) but also characteristics more commonly associated with equities (such as access to real time pricing and trading).

The last few years have witnessed a dramatic growth in ETFs, both in terms of assets invested and the number of products available. They have proved attractive to both retail and institutional investors, in some cases due to competitive fee arrangements and in others due to the ability to offer access to a particular market or sector exposure in a highly efficient manner.

### 6.1 ETFs and the UCITS Framework

This Chapter provides a high level summary of UCITS which are ETFs and which can use the “UCITS ETF” identifier. For a more detailed review, including relevant tax and listing issues, see Dillon Eustace publication “**Exchange Traded Funds and the UCITS Framework**” (November 2014).

### 6.2 Advantages of ETFs

The scope of the ETF products on offer has widened with ETFs now covering a broad range of asset classes as well as specific sectors and also offering active strategies in addition to the more traditional passive ETFs products that the market has come to know. Some of the advantages of investing in ETFs are considered to include:

- (i) *Low Costs.* The decreased level of portfolio transactions means that an ETF may be subject to lower transaction costs than a traditional index tracking fund.
- (ii) *Diversification and choice.* Investment in an index tracking product will generally provide investors with diversification, as available ETFs cover indices on most major equity markets.
- (iii) *Transparency.* The components of the basket for the purchase or sale or creation of units are published on each dealing day.

- (iv) *Liquidity.* Intra-day trading at real-time pricing enables investors to buy and sell their shares at any time throughout the day.
- (v) *Shorting and margin.* As an ETF share is an exchange traded security, it can usually be treated by investors as similar to an equity security and so can be sold short or purchased on margin, subject to regulatory restrictions that may apply.
- (vi) *Flexibility.* ETFs attract both active traders and long-term investors. Investment managers may utilise ETFs where they find it difficult to outperform a certain market / market sector.

### 6.3 UCITS ETFs Regulatory Requirements

ESMA's "Guidelines on ETFs and other UCITS issues" introduced new requirements in relation to "UCITS ETFs" which are now reflected in the Central Bank's UCITS Notices.

A "UCITS ETF" is defined in the UCITS Notices as a UCITS "at least one unit or share class of which is traded throughout the day on at least one regulated market or multilateral trading facility with at least one market maker which takes action to ensure that the stock exchange value of its units does not significantly vary from its net asset value and where applicable its indicative net asset value."

### 6.4 Identifier and specific disclosure

In order to make investors aware of the distinction between exchange traded UCITS and traditional open-ended UCITS, a UCITS ETF is required to use the identifier "**UCITS ETF**" which identifies it as an exchange-traded fund. If all the sub-funds are UCITS ETFs, the labelling requirement applies at the sub-fund level and the UCITS may decide to apply it to the umbrella level as well. However, if not all the sub-funds are UCITS ETFs, the labelling requirement only applies to the relevant UCITS ETF sub-funds.

The ETF identifier should be used in the name of the UCITS in the constitutive document (trust deed, deed of constitution, articles of association or instrument of incorporation) prospectus, key investor information document and marketing communications. A UCITS which is not a UCITS ETF may not use the "UCITS ETF" identifier nor "ETF" nor "exchange-traded fund".

A UCITS ETF is required to disclose clearly in its prospectus, key investor information document and marketing communications its policy regarding portfolio transparency and where information on the portfolio may be obtained, including where the indicative net asset value, if applicable, is

published. The manner in which the indicative net asset value, if applicable, is calculated and the frequency of the calculation thereof must also be disclosed clearly in the prospectus.

## 6.5 Actively-managed UCITS ETFs

The prospectus of any actively-managed UCITS (*being a UCITS ETF where the manager has discretion over the composition of its portfolio subject to the stated investment objectives and policies as opposed to a passively managed UCITS ETF which tracks an index*) must make clear that the fund does not track an index and that it is actively managed by the fund manager. Information should also be provided on how the fund manager intends to meet its investment policy, including where applicable its intention to outperform an index.

## 6.6 Primary and Secondary Markets

In looking at how investors access (and redeem out of) ETFs, it is important to note at the outset that one or more market makers (referred to as “Authorised Participants”) will be appointed by an ETF to (i) subscribe for and redeem ETF shares directly from the ETF but usually only in large blocks called creation units and (ii) make a market in the ETF shares in the secondary market.

### (i) *Payment for Creation Units*

Payment for a creation unit (comprising a designated number of shares) may be provided in cash or in-kind by the delivery of a basket of securities and other assets (i.e. cash) which, (i) in the case of a passive ETF that is physically replicated, closely replicates the composition and weighting of the securities held within the relevant index or (ii) in the case of an actively managed ETF, is representative of the ETF's portfolio and is equal in value to the net asset value of the ETF shares in the creation unit.

### (ii) *Primary Market Redemptions*

Primary market redemptions may normally be effected by the Authorised Participant requesting the redemption of its ETF shares directly from the ETF. Such redemption requests must correspond in size with one or more creation units. Once the redemption request is processed, the relevant ETF shares are cancelled and the Authorised Participant will receive cash or, where redemptions in kind are processed, securities and other assets representative of the relevant index/portfolio.

(iii) *Secondary Market*

The ETF shares will be listed on an exchange (such as the London Stock Exchange) where they can be freely purchased and sold, with the settlement of trades in ETF shares on an exchange being facilitated through one or more recognised settlement systems, for example, CREST, Clearstream or Euroclear. As a result, investors can buy and sell ETF shares in large or small amounts through the exchange on a real time, intra-day basis without attracting subscription or redemption charges.

## 6.7 Treatment of Secondary Market investors of UCITS ETFs

One of the requirements introduced by ESMA under the “Guidelines on ETFs and other UCITS issues” is that if the stock exchange value of the units of a UCITS ETF significantly varies from its net asset value, investors who have acquired their units on the secondary market must be allowed to sell them directly back to the UCITS ETF (for example, this may apply in cases of market disruption such as the absence of a market maker).

(i) *Communication*

In such situations, information is required to be communicated to the regulated market indicating that the UCITS ETF is open for direct redemptions at the level of the UCITS ETF. In addition, a UCITS ETF must disclose in its prospectus the process to be followed by investors who purchased their units on the secondary market should the above circumstances arise, as well as the potential costs involved (which costs should not be excessive).

(ii) *Issues for Corporate Funds*

The requirement to facilitate direct redemptions by investors in the secondary market needs to be carefully considered by Irish UCITS structured as corporate ETFs due to an Irish company law provision which prohibits corporate entities from recognising (or taking instructions from) any party other than the legal / registered shareholder of shares.

Accordingly, a UCITS structured as a corporate ETF would not be in a position to facilitate direct redemptions requests from beneficial owners on the secondary market. In order to initiate a direct redemption and pending changes to the existing legislative regime, one practical solution may be for the beneficial holder to instruct the authorised participant (as the registered shareholder) to arrange for a direct redemption of its shares with the relevant transfer agent.

*(iii) Risk Warning*

Where units of a UCITS ETF purchased on a secondary market are not redeemable from the UCITS, the prospectus and marketing communications of the UCITS is required to include a risk warning to that effect (in the form prescribed by the Central Bank).



## 7. UCITS Investing in other Collective Investment Schemes

UCITS are subject to quite prescriptive rules on investing in other *open-ended* collective investment schemes (“**CIS**”). Those rules relate primarily to the types of other CIS in which a UCITS can invest; to the extent to which investment can be made by a UCITS in an eligible CIS and to fee disclosures.

Note that, as explained further in section 7.9 below, open-ended ETFs are considered to be CIS for UCITS investment purposes, not transferable securities. Therefore, notwithstanding that the shares in an ETF may be admitted to listing and be dealt in on one or more leading international exchanges, in order to be eligible for investment by a UCITS, the ETF must meet the eligibility tests for UCITS investments in CIS.

UCITS can, of course, invest in certain types of *closed-ended* funds where such investments are treated as investments in transferable securities.

### 7.1 Types of Eligible CIS

UCITS are permitted to invest up to 100% of their assets in other open-ended CIS where:

- (i) those CIS are other UCITS or other EU or non-EU CIS within the meaning of Regulation 4(3) of the UCITS Regulations (*i.e. the sole object of which is the collective investment in transferable securities and/or in other liquid financial assets of capital raised from the public and which operate on the principle of risk spreading and the units of which are at the request of holders, repurchased or redeemed, directly or indirectly out of those undertakings assets*) provided that:
  - (a) such other CIS are authorised under laws which provide that they are subject to supervision considered by the Central Bank to be equivalent to that laid down in community law and that co-operation between authorities is sufficiently insured;
  - (b) the level of protection for unitholders in the other CIS is equivalent to that provided for investors in a UCITS and in particular that the rules on assets segregation, borrowing, lending and uncovered sales of transferable securities and money market instruments are equivalent to the requirements of the UCITS;
  - (c) the business of the other CIS is reported in half-yearly and annual reports to enable an assessment to be made of the assets and liabilities, income and operations over the reporting period; and

- (ii) not more than 10% of the UCITS or other CIS assets, whose acquisition is contemplated can, according to its trust deed, deed of constitution or articles, be invested in aggregate in units of other UCITS or other CIS.

## 7.2 Investment Restrictions

In addition to the restrictions on the types of non-UCITS CIS that a UCITS may invest in, there are four main investment restrictions which apply to UCITS investing in other CIS, which are that:

- (i) the maximum exposure to any one CIS may not exceed 20% of the net asset value of the investing UCITS (each sub-fund of an underlying umbrella CIS being regarded as a separate CIS for the purpose of applying this limit);
- (ii) the maximum investment in non-UCITS CIS may not in aggregate exceed 30% of the net asset value of the UCITS;
- (iii) investment in a CIS which can itself invest more than 10% of net assets in other CIS is not permitted; and
- (iv) investment in a CIS must not result in the acquisition of more than 25% of the units of any single CIS (or sub-fund of an umbrella CIS).

**NOTE:** UCITS IV introduced UCITS master-feeder structures under which a UCITS may invest (by way of derogation from the above 20% limit) 100% of its assets in another UCITS. In fact, in order to avail of that master/feeder permission, the investing feeder UCITS must invest at least 85% of its assets into the UCITS master. This capacity is addressed in more detail in Chapter 8.

## 7.3 Acceptable Types of Non-UCITS CIS

The Central Bank has indicated in its Guidance Note 2/03 that it will permit investment by UCITS in the following categories of non-UCITS CIS:

- (i) schemes established in Guernsey and authorised as Class A schemes;
- (ii) schemes established in Jersey as Recognised Funds;
- (iii) schemes established in the Isle of Man as Authorised Schemes;

- (iv) non-UCITS Retail CIS authorised by the Central Bank itself provided such CIS comply *in all material respects* with the provisions of the UCITS Notices; and
- (v) non-UCITS CIS authorised in a Member State of the EEA, the United States, Jersey, Guernsey or the Isle of Man and which comply *in all material respects* with the provisions of the UCITS Notices.

#### 7.4 Central Bank's consideration of "*in all material respects*"

The final two categories listed at points (iv) and (v) above are subject to an "*in all material respects*" criterion. The Central Bank's consideration of "all material respects", includes, inter alia, consideration of:

- (i) the existence of an independent trustee/custodian with similar duties and responsibilities to those of Irish trustees/custodians in relation to both safekeeping and supervision;
- (ii) requirements for the spreading of investment risk, including concentration limits, ownership restrictions, leverage and borrowing restrictions, etc.;
- (iii) availability of pricing information and reporting requirements;
- (iv) redemption facilities and frequency; and
- (v) restrictions in relation to dealings by related parties.

#### 7.5 Other Jurisdictions?

As indicated above, the Central Bank has listed a number of jurisdictions and types of CIS which it considers to be acceptable for investment by a UCITS.

Other jurisdictions and types of CIS may be considered by the Central Bank on submission to it and, in assessing any such submissions, the Central Bank has indicated in its Guidance Note that it will have regard to:

- (i) any memoranda of understanding (bi-lateral or multi-lateral), membership of an international organisation of regulators or other co-operative arrangements, (such as exchange of letters) to ensure satisfactory co-operation between the Central Bank and the competent authority of the relevant CIS;

- (ii) whether the management company of the target CIS, its rules and its choice of trustee have been approved by its own regulator; and
- (iii) whether the CIS is authorised in an OECD jurisdiction.

## 7.6 Central Bank's consideration of "equivalence" for Non-UCITS CIS

In order for a Non-UCITS CIS to be an acceptable investment of a UCITS, the Central Bank needs to be satisfied that:

- (i) it is authorised under a legislative regime which provides that it is subject to supervision considered by the Central Bank *to be equivalent* to that specified in Community law and that co-operation between authorities is sufficiently ensured;
- (ii) it is subject to a regulatory regime such that the level of protection for investors is *equivalent* to that provided for investors in a UCITS and, in particular, that the rules on segregation of assets, borrowing, lending and uncovered sales of transferable securities and money market instruments are *equivalent* to the requirements by the UCITS Directive; and
- (iii) it is required to report on a half-yearly and annual basis to enable an assessment to be made of the assets and liabilities, income and operations over the reporting period.

In its Guidance Note 2/03, the Central Bank has indicated that the following factors can be used by it to guide its decision on equivalence:

- (a) rules guaranteeing the autonomy of the management of the CIS, and management in the exclusive interest of the unitholders;
- (b) the existence of an independent trustee/custodian with similar duties and responsibilities in relation to both safekeeping and supervision. Where an independent trustee/custodian is not a requirement of local law, robust governance structures may provide a suitable alternative;
- (c) availability of pricing information and reporting requirements;
- (d) redemption facilities and frequency;
- (e) restrictions in relation to dealings by related parties;
- (f) the extent of asset segregation; and

- (g) local requirements for borrowing, lending and uncovered sales of transferable securities and money market instruments regarding the portfolio of the CIS.

## 7.7 Fees/Charges and Disclosures

Where a UCITS invests in a linked CIS (where both the UCITS and CIS are managed, directly or indirectly by delegation by the same management company or where the management company of both the UCITS and underlying CIS are linked by common management or control or by a substantial direct or indirect holding), the manager of the underlying CIS is not permitted to charge subscription or redemption fees to the UCITS investing in it.

Where a UCITS intends to invest more than 20% of its net assets in other CIS, its prospectus must disclose the maximum level of management fees that may be charged to the UCITS itself and to the underlying CIS. In other words, the aggregate management fees at both levels have to be disclosed.

In addition, actual aggregate management fees at both levels have to be disclosed in the UCITS annual report.

## 7.8 Cross Investment in UCITS umbrella funds

One sub-fund of a UCITS umbrella can invest in one or more other sub-funds of the same umbrella provided that such cross-investment may not be made in a sub-fund which, itself, holds units in other sub-funds within the umbrella. Where the UCITS umbrella is an investment company type scheme, cross-investment is only permitted where the umbrella scheme or its delegate (i.e. the administrator) has the systems capability to provide disclosure in relation to cross-holdings in accordance with industry adopted standards.

Note that the investing sub-fund may not charge an annual management fee (or investment management fee) in respect of that portion of its assets invested in the other sub-funds of the same umbrella. The prohibition on charging subscription and redemption charges referred to in section 7.7 will also apply.

## 7.9 Impact of ESMA Opinion on interpretation of Article 50(2)(a) of the UCITS Directive

As mentioned above, shares in open-ended ETFs are, for UCITS in investment purposes, now considered to be shares in CIS and not “transferable securities”. Therefore, if the target is a UCITS ETF, the investing UCITS can invest up to 20% of net assets in the UCITS ETF (once the latter

cannot itself invest more than 10% of its net assets in other funds), rather than being subject to the 5/10/40 rule.

However, if the target ETF is not a UCITS ETF, then in order for the UCITS to be able to invest in it at all, it has to meet the eligibility tests for investments in Non-UCITS CIS (and will be subject to the aggregate 30% limit on investing in Non-UCITS CIS, as well as the single CIS 20% limit). That can be sometimes problematic and requires a full assessment on each occasion.

This (in our view, unwelcome and unnecessary) position has arisen due to ESMA's November 2012 Opinion on the interpretation of Article 50(2)(a) of the UCITS Directive which was issued in response to legitimate concerns as to potential misuse of that Article to bring unregulated funds within the aggregate 10% limit set out in that Article 50(2)(a), commonly referred to as the "*trash basket*".

Article 50(2)(a) provides that a UCITS may not invest more than 10% in aggregate of its assets in transferable securities and money market instruments which do not meet the UCITS eligibility requirements as detailed in Article 50(1) (i.e. they are not admitted to or dealt in on a regulated market which operates regularly and is open to the public).

On 20th November, 2012, ESMA published a formal opinion on its interpretation of Article 50(2)(a), the central thrust of which was that Article 50(2)(a) only referred to "transferable securities" and to "money market instruments" and not to "CIS". ESMA's opinion was that, as CIS were expressly dealt with under a different Article, Article 50(1)(e), that meant that Article 50(2)(a) could not be used to permit investment in investment funds. That was not, in itself, objectionable. The real concern was that, to justify its position, it decided that if an issuer of a share was an open-ended fund then, notwithstanding that its shares were listed and traded intra-day on an exchange just like the shares of leading blue chip corporate issuers, its shares could not be treated as "transferable securities" and could only be treated as CIS.

This has had the consequence of excluding some Non-UCITS ETFs from UCITS investment eligibility, particularly where the trust deed or deed of constitution or articles of that Non-UCITS ETF does not contain a prohibition on investing more than 10% of net assets in other funds.

## 8. Master Feeder UCITS

Under the original 1985 Directive, UCITS were not permitted in other collective investment schemes at all. As explained in Chapter 7, that changed under UCITS III and, since UCITS IV has been implemented, it is now possible to have UCITS master / feeder structures.

### 8.1 Master / Feeder Requirements

The basic rules for UCITS master / feeders are that:

- (i) the feeder fund must be a UCITS and must invest at least 85% of its assets in units of the master fund; and
- (ii) the master fund must also be a UCITS.

The Central Bank's conditions for the master / feeder UCITS are set out in UCITS Notice 18.

### 8.2 Other permissible asset types

Up to 15% of the assets of the feeder can be invested in other types of assets (ie. other than in units of the master), including ancillary liquid assets, financial derivative instruments (in which case, the global exposure of the feeder UCITS must be calculated taking into account global exposure at the level of the underlying master) and movable and immovable property (where essential for the direct pursuit of the business, if the feeder UCITS is an investment company).

### 8.3 Criteria for Master UCITS

A master UCITS is a UCITS (or sub-fund of an umbrella UCITS) which:

- (i) has among its investors at least one feeder;
- (ii) is not itself a feeder; and
- (iii) does not hold units / shares of another feeder UCITS.

**Note:** The requirement to raise capital from the public does not apply in the case of a master UCITS, which has at least two feeder UCITS as investors.

A master UCITS must also satisfy the following requirements:

- it must provide its feeder with all documents and information necessary for the feeder UCITS to comply with its obligations;
- it must immediately inform the Central Bank of the identity of each feeder UCITS which invests in its units / shares;
- it cannot charge subscription or redemption fees to its feeder UCITS; and
- it must have arrangements in place in order to ensure the timely availability of all information the master is obliged to provide under the UCITS Regulations.

In the event that a master UCITS and its feeder UCITS have different accounting years, the auditor of the master must make an *ad hoc* report on the closing date of the feeder UCITS.

## 8.4 Common provisions for feeder and master UCITS

A feeder UCITS must enter into an agreement with a master UCITS prior to investment in the master. That agreement must be available on request (and free of charge) to all unitholders and it must contain or deal with the following:

- (i) provisions for access to information relating to the master UCITS;
- (ii) the basis of investment and disinvestment by the feeder UCITS;
- (iii) standard dealing arrangements;
- (iv) events affecting dealing arrangements;
- (v) standard arrangements for the audit report;
- (vi) changes to standing arrangements (for example, changes to the constitutional documents etc); and
- (vii) choice of applicable law.

Alternatively, where the feeder and the master are managed by the same management company such an agreement can be replaced with *internal conduct of business rules* which must contain the matters outlined at (ii) - (iv) above as well as measures to mitigate conflicts of interest.

A master UCITS and feeder UCITS must also take appropriate measures to co-ordinate the timing of their NAV calculations and publications in order to avoid market timing and to prevent arbitrage opportunities.

## 8.5 Monitoring Obligation

The feeder UCITS must monitor effectively the activity of the master UCITS. To do so, the feeder can rely on information and documents received from the master or, where applicable, from its management company, custodian / trustee and auditor, unless there is reason to doubt the accuracy of that information and documentation.

## 8.6 Custodians / Trustees

The custodian / trustee of a master UCITS must immediately inform the Central Bank, its feeder UCITS and the custodian / trustee of the feeder of any irregularities it detects (including NAV errors and breaches of investment objectives, restrictions and borrowing limits) with regard to the master UCITS which are deemed to have a negative impact on the feeder UCITS.

If a feeder and master have different custodians / trustees, then the custodian / trustee of the feeder UCITS must enter into an information sharing agreement with the custodian / trustee of the master UCITS prior to investment / to cover such matters as documents to be routinely shared, the manner and timing of sharing information, the co-ordination of both custodians / trustees in certain operational matters, the co-ordination of accounting year end procedures, sharing of information with regard to breaches at the level of the master fund etc.

## 8.7 Auditors

The auditors of a feeder UCITS must report on any irregularities in the audit report of the master UCITS and on the impact on the feeder UCITS.

Likewise, if a feeder and master have different auditors, the auditors of the feeder must enter into an information sharing agreement with the auditors of the master UCITS prior to investment.

## 8.8 Central Bank Approval

Prior Central Bank approval is required for UCITS master / feeders. Approval will only be granted if the feeder UCITS, the master UCITS, the custodian / trustee and the auditors satisfy certain conditions and approval is also dependant on the submission of various documents to the Central

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Bank. An application for approval of a UCITS master / feeder must be accompanied by the following documents:

- (i) the constitutional documents of both the feeder and the master;
- (ii) the prospectus and key information document of both;
- (iii) the agreement between the feeder and the master or the internal conduct of business rules;
- (iv) where applicable, particular information to be provided to investors;
- (v) where applicable, the information sharing agreement between the custodian / trustee of the feeder and the custodian / trustee of the master;
- (vi) where applicable, the information sharing agreement between the auditor of the feeder and that of the master; and
- (vii) where applicable, an attestation from the competent authority of the master UCITS regarding its status.

## 8.9 Prospectus Disclosure

The prospectus of the feeder UCITS must contain certain disclosures including a prominent statement that it is a feeder and giving the name of the master in which it invests 85% or more of its net assets. The feeder's prospectus must also disclose particular information in relation to the master, including information as to its investment objective and policy. It must also disclose the aggregate charges at the level of both the feeder and master; as well as tax implications for the feeder arising from investment in the master.

## 8.10 Conversion of non-feeder UCITS to a feeder UCITS or change of master UCITS

If a non-feeder UCITS proposes to convert into a feeder UCITS or if a feeder UCITS proposes to change its underlying master UCITS, then prior investor approval must be obtained.

That requires that particular information be sent to investors at least 30 days before the proposed investment, including the key information document of both the feeder and the master, the date on which the changes take effect and a statement as to the investors' right of redemption within 30 days, without charge.

## 8.11 Provisions in the case of liquidation, merger or division of Master UCITS

The following conditions apply in the case the underlying master UCITS is either liquidated or subject to a merger or division:

(i) *Liquidation of master UCITS*

In the event that the master UCITS is liquidated, the feeder UCITS must also be liquidated unless the feeder UCITS has obtained approval from the Central Bank to invest as a feeder in another master or to convert to a non-feeder.

The feeder UCITS must submit certain documents to the Central Bank within two months from the date on which the master UCITS informed it of the binding decision to liquidate. The nature of such documents will depend on whether the UCITS intends to (i) invest as a feeder in another master (ii) convert to a non-feeder or (iii) be liquidated.

(ii) *Merger or division of master UCITS*

In the event that a master UCITS merges with another UCITS or is divided into two or more UCITS, the feeder UCITS must be liquidated unless the feeder UCITS has obtained approval from the Central Bank to either continue as a feeder of the master or of another UCITS resulting from the merger or to invest as a feeder into another master or to convert to a non-feeder.

The feeder must submit certain documents to the Central Bank within one month from the date on which it received information regarding the planned merger or division. Again, the nature of such documents will depend on whether the UCITS intends to (a) continue as a feeder of the same master (b) invest as a feeder in another master (c) convert to a non-feeder or (d) be liquidated.

In either of the above circumstances, the feeder UCITS must inform the master UCITS of its decision. In the event that a decision is taken to liquidate the feeder UCITS, it must also inform investors of this intention without undue delay.



## 9. UCITS investing in Financial Derivative Instruments

UCITS can invest in financial derivative instruments (“**FDI**”) for investment purposes (ie. not just for EPM purposes), subject to a variety of conditions as outlined below relating to the nature of the exposures taken, the leverage generated through such positions, the process employed by the UCITS to manage the risks arising from derivatives investment as well as rules relating to OTC counterparty exposure and to the valuation of derivatives positions.

### 9.1 Relevant Notices / Guidance Notes

The risk management conditions that must be met by Irish UCITS investing in exchange traded or over-the-counter (OTC) derivative instruments for investment purposes, have been set down by the Central Bank in:

- (i) *UCITS Notice 9*: which sets out investment restrictions applicable to UCITS including limits on counterparties and certain counterparty criteria;
- (ii) *UCITS Notice 10*: which sets out high level derivatives rules including summary of permitted derivatives, cover requirements and risk management requirements; and
- (iii) *Guidance Note 3/03*: which contains detailed provisions for the use of derivatives by UCITS.

### 9.2 Conditions for the use of derivatives by UCITS

As outlined in UCITS Notice 10, UCITS may invest in any type of exchange traded or OTC derivative for investment purposes, subject to the following conditions:

- (i) that the underlying asset relates to UCITS eligible assets (i.e. transferable securities, money market instruments, CIS, deposits), including financial instruments having one or several characteristics of these assets, or to financial indices, interest rates, foreign exchange rates or currencies;
- (ii) that the counterparties to OTC derivative transactions are institutions which are subject to prudential supervision and belong to categories approved by the Central Bank (qualifying credit institutions, MiFID authorised investment firms or an entity subject to regulation as a Consolidated Supervised Entity by the US Securities and Exchange Commission) with a minimum credit rating (in the case of counterparties which are not credit institutions) of A2 or equivalent, or an implied rating of A2 or guaranteed by an entity with a rating of A2;

- (iii) in the case of subsequent novation of the OTC derivative contract, the counterparty is one of:
- the entities set out above or;
  - a central counterparty (CCP) authorised, or recognised by ESMA, under Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (“**EMIR**”) or, pending recognition by ESMA under Article 25 of EMIR, an entity classified as a derivatives clearing organisation by the Commodity Futures Trading Commission or a clearing agency by the SEC (both CCP).

Positions may create long or short exposure to the underlying asset and may result in leverage to the portfolio. Note that UCITS which use derivatives for investment (or for EPM) purposes must prepare a Risk Management Process and file it for approval with the Central Bank. In addition, adequate disclosure of derivative investments must be made in the UCITS’ prospectus. Specific provisions in this regard are outlined in Central Bank Guidance Note 3/03.

### 9.3 Guidance Note 3/03

Guidance Note 3/03 was produced by the Central Bank to outline clearly the parameters for the use of derivatives by UCITS and to provide guidance on what the Central Bank expects in relation to the measurement and control of derivatives associated risk by UCITS. It was updated as part of UCITS IV in order to reflect the ESMA Guidelines on Risk Measurement and the calculation of Global Exposure and Counterparty Risk for UCITS dated July 28, 2010.

Guidance Note 3/03 contains detailed requirements in relation to (i) measuring and controlling global exposure (by the use of the commitment approach or VaR); (ii) the use of OTC derivatives including counterparty risk and issuer concentration; (iii) the use of techniques and instruments (including repurchase and reverse repurchase agreements and stock lending) for the purpose of efficient portfolio management; (iv) cover, (v) reporting, (vi) the UCITS annual Financial Derivative Instruments report and prospectus disclosure; and (vii) the format and content of the Risk Management Process.

### 9.4 Risk Management Process

In order to monitor, measure and manage the risk profile of a UCITS, its investment manager must construct a formal Risk Management Process (“**RMP**”) which is adapted to the complexity of the particular derivatives used within that UCITS. The RMP must be prepared in accordance with

Guidance Note 3/03 and submitted to the Central Bank for approval as part of the UCITS application for authorisation.

The RMP must give information on the trading process employed by the investment manager and should explain in detail the responsibilities and expertise of the personnel involved in the derivative trading activity of the UCITS. It should also explain clearly all the types of derivative instruments used by the UCITS and their specific purpose. The RMP should also explain the following:

- (i) how the various exposures (global exposure and leverage, counterparty exposure etc.) are measured;
- (ii) which limits apply to each such exposure;
- (iii) how those limits are monitored and enforced; and
- (iv) how breaches of limits are reported and escalated.

A worked example of exposure calculations should also be provided which should incorporate examples of each type of derivative and should also demonstrate how hedging is used.

Any material amendments to the RMP must be addressed in a revised RMP which must be notified to the Central Bank in advance. Any non-material amendments or updates to the RMP (for example change of personnel or systems) should be included as part of the annual Financial Derivative Instruments report.

## 9.5 Measurement of Global Exposure

The concept of “global exposure” is considered to be a measure of incremental exposure and leverage generated by a UCITS using financial derivative instruments.

UCITS Notice 10 provides that a UCITS can calculate its global exposure by using the commitment approach or the value at risk (“**VaR**”) approach or other advanced risk measurement methodologies, as may be appropriate. The UCITS must ensure that the method is appropriate taking into account its investment strategy, the types and complexities of the FDI used and the proportion of its portfolio which comprises FDI. A leveraged index-tracking UCITS must calculate its global exposure by using the commitment approach or the relative VaR approach.

## 9.6 Commitment Approach

A UCITS using the commitment approach must ensure that its global exposure does not exceed its NAV. The UCITS may not, therefore, be leveraged in excess of 100% of its NAV.

The commitment conversion methodology for standard derivatives is always the market value of the equivalent position in the underlying asset. This may be replaced by the notional value or the price of the futures contract, where this is more conservative. For non-standard derivatives, where it is not possible to convert the derivative into the market value or notional value of the equivalent underlying asset, an alternative approach may be used provided that the total amount of the derivatives represent a negligible portion of the UCITS portfolio.

## 9.7 VaR

UCITS Notice 10 expressly provides that a UCITS must use an advanced risk measurement methodology (supported by a stress testing program) such as the VaR approach to calculate global exposure where:

- (i) the UCITS engages in complex investment strategies which represent more than a negligible part of the UCITS investment policy; and/or
- (ii) the UCITS has more than a negligible exposure to exotic derivatives; and/or
- (iii) the commitment approach does not adequately capture the market risk of the UCITS portfolio.

VaR is defined as a measure of the maximum expected loss at a given confidence level over a specific time period. The Central Bank requires that the VaR model employed by the UCITS meets certain quantitative and qualitative criteria and be calculated using an acceptable proprietary or commercially available model. Furthermore, following its initial development, the model should undergo a validation by a party independent of the building process to ensure that the model is conceptually sound and adequately captures all material risks.

## 9.8 Absolute or Relative VaR?

Absolute VaR or relative VaR may be applied. The UCITS is responsible for deciding which VaR approach is the most appropriate methodology given its risk profile and investment strategy.

The *absolute VaR* approach limits the maximum VaR that a UCITS can have relative to its NAV. The absolute VaR of a UCITS cannot be greater than 20% of its NAV.

Under the *relative VaR* approach, the global exposure of the UCITS is calculated as follows: (i) calculate the VaR of the UCITS current portfolio (which includes derivatives); (ii) calculate the VaR of a reference portfolio (which reference portfolio should, except in limited circumstances, be unleveraged and not contain any FDI or embedded FDI); (iii) check that the VaR of the UCITS portfolio is not greater than twice the VaR of the reference portfolio.

The VaR model used must adhere to the following requirements:

- (i) one-tailed confidence interval of 99%;
- (ii) holding period equivalent to one month (20 business days);
- (iii) minimum historical observation period of one year (250 business days) unless a shorter period is justified by a significant increase in price volatility (for instance extreme market conditions);
- (iv) quarterly data set updates, or more frequent when market prices are subject to material changes;
- (v) at least daily calculation;
- (vi) stress testing at least monthly (to measure any potential major depreciation of a UCITS value as a result of unexpected changes in the relevant market parameters and correlation factors);
- (vii) back testing (a formal statistical process to compare actual portfolio returns to the VaR predicted) at least monthly and any “overshootings” (a one-day change in the portfolio’s value that exceeds the related one-day value-at-risk measure calculated by the model) to be determined and monitored on the basis of such back testing program.

A confidence interval and/or a holding period differing from the default parameters above may be used by a UCITS provided that the confidence interval is not below 95% and the holding period does not exceed 1 month (20 days).

## 9.9 Netting

Netting arrangements are defined in UCITS Notice 10.6 as combinations of trades on financial derivative instruments and/or security positions which refer to the same underlying asset, irrespective – in the case of financial derivative instruments – of the contracts due date; and where the trades on financial derivative instruments and/or security positions are concluded with the sole aim of eliminating the risks linked to positions taken through the other financial derivative instruments and/or security positions.

Netting is permitted in the following situations:

- (i) between financial derivative instruments, provided they refer to the same underlying asset, even if the maturity date of the financial derivative instruments is different;
- (ii) between a financial derivative instrument (whose underlying asset is a transferable security, money market instrument or a collective investment undertaking) and that same corresponding underlying asset;
- (iii) a UCITS that invests primarily in interest rate derivatives may make use of specific duration-netting rules in order to take into account the correlation between the maturity segments of the interest rate curve.

## 9.10 Hedging

Hedging arrangements are defined in UCITS Notice 10.6 as combinations of trades on financial derivative instruments and/or security positions which do not necessarily refer to the same underlying asset and where the trades on financial derivative instruments and/or security positions are concluded with the sole aim of offsetting risks linked to positions taken through the other financial derivative instruments and/or security positions.

Hedging arrangements may be taken into account when calculating global exposure if they offset the risks linked to some assets and, in particular, if they comply with all of the following criteria:

- (i) investment strategies that aim to generate a return should not be considered as hedging arrangements;
- (ii) there should be a verifiable reduction of risk at the UCITS level;

- (iii) the risks linked to financial derivative instruments (ie., general and specific) if any, should be offset;
- (iv) they should relate to the same asset class; and
- (v) they should be efficient in stressed market conditions.

Notwithstanding the above criteria, financial derivative instruments used for currency hedging purposes (i.e. that do not add any incremental exposure, leverage and/or other market risks) may be netted when calculating a UCITS' global exposure.

Market neutral or long/short investment strategies will not comply with all the criteria set out above.

## 9.11 Position Exposure

Position exposure to the underlying assets of derivatives, including embedded derivatives in transferable securities, money market instruments or collective investment schemes, when combined where relevant with positions from direct investments, may not exceed the general investment limits.

That exposure must be calculated using the commitment approach when appropriate or the maximum potential loss as a result of default by the issuer, if more conservative.

A combination of the following issued by, or made or undertaken with the same body may not exceed 20% of a UCITS' net asset value:

- (i) transferable securities or money market instruments;
- (ii) deposits; and/or
- (iii) counterparty risk exposures from OTC derivative transactions; and/or
- (iv) position exposure to the underlying assets of derivatives.

There is no look through to underlying assets in respect of index derivatives, provided the index meets certain criteria.

## 9.12 Position Cover Requirements

A transaction in FDI which gives rise, or may give rise, to a future commitment on behalf of a UCITS must be covered as follows:

- (i) in the case of FDI which automatically, or at the discretion of the UCITS, are cash settled, the UCITS must hold, at all times, liquid assets which are sufficient to cover the exposure (exposure valued on mark to market basis and defined as the net liability to the counterparty).
- (ii) in the case of FDI which require physical delivery of the underlying asset, the asset must be held at all times by the UCITS. However, the UCITS may alternatively cover the exposure with sufficient liquid assets where:
  - (a) the underlying asset consists of a highly liquid fixed income security; and/or
  - (b) the investment manager considers that the exposure can be adequately covered without the need to hold the underlying asset where the specific FDI are addressed in the risk management statement and details are provided in the prospectus.

## 9.13 Counterparty Exposure Limits

Counterparty exposure limits are imposed on UCITS. Exposure is limited to 5% of net asset value or 10% in the case of certain credit institutions as follows:

- (i) a credit institution authorised in the EEA;
- (ii) a credit institution authorised within a signatory state (other than an EEA Member State) to the Basle Capital Convergence Agreement of July 1998; or
- (iii) a credit institution authorised in Jersey, Guernsey, the Isle of Man, Australia or New Zealand.

When calculating counterparty exposure, a UCITS must include all exposures to the counterparty (i.e. exposure related to OTC derivatives and any other exposure to the counterparty).

Netting can be applied, as appropriate, before counterparty exposure is calculated and, in addition, risk can be reduced where a counterparty provides acceptable collateral to the UCITS in accordance with the Central Bank requirements, as further outlined below.

Any exposure arising from initial margin posted to and variation margin receivable from a broker relating to exchange-traded or OTC derivatives which is not protected by client money rules or other similar arrangements to protect the UCITS against the insolvency of the broker must be calculated within the OTC counterparty limit, as referred to above.

## 9.14 Collateral

Strict collateral rules apply in respect of collateral received to reduce counterparty risk exposure where a UCITS enters into OTC derivatives (or uses efficient portfolio management techniques). Such collateral must at all times comply with, *inter alia*, the following criteria:

- (i) it must be highly liquid and traded on a regulated market or multilateral trading facility with transparent pricing;
- (ii) it must be valued on at least a daily basis;
- (iii) it must be of high quality;
- (iv) it must be issued by an entity that is independent from the counterparty and is not expected to display a high correlation with the performance of the counterparty;
- (v) it must be sufficiently diversified in terms of country, markets and issuers with a maximum exposure to a given issuer of 20% of the net asset value of the UCITS; and
- (vi) it must be capable of being fully enforced by the UCITS at any time without reference to or approval from the counterparty.

In addition, risks linked to the management of collateral must be identified, managed and mitigated by the UCITS' risk management process. Cash collateral can only be invested in a restricted list of assets and any re-invested cash collateral is required to be diversified in accordance with the diversification requirements applicable to non-cash collateral.

Finally, a UCITS is required to have a documented haircut policy adapted for each class of asset received as collateral. Further, if a UCITS receives collateral for at least 30% of its assets, it is required to have an appropriate stress testing policy in place to ensure regular stress tests are carried out to enable it to assess the liquidity risk attached to collateral.

## 9.15 Embedded Derivatives

Asset managers must take care to examine the true nature of instruments they seek to invest a UCITS in to determine whether they “embed” derivatives. If a transferable security or money market instrument does embed a financial derivative instrument (FDI), then the global exposure, issuer-concentration and leverage calculation rules referred to above apply to the embedded FDI element of the transferable security or money market instrument.

As provided in UCITS Notice 10, a transferable security or money market instrument will be considered to embed a FDI where it contains a component which fulfils the following criteria:

- (i) by virtue of that component some or all of the cash flows that otherwise would be required by the transferable security or money market instrument which functions as host contract can be modified according to a specified interest rate, financial instrument price, FX rate, index of prices or rates, credit rating or credit index, or other variable, and therefore vary in a way similar to a stand-alone derivative;
- (ii) its economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract;
- (iii) it has a significant impact on the risk profile and pricing of the transferable security or money market instrument in question.

However, note that a transferable security or a money market instrument shall not be regarded as embedding a FDI where it contains a component which is contractually transferable independently of the transferable security or the money market instrument. Such a component shall be deemed to be a separate financial instrument.

Central Bank Guidance Note 3/03 sets out the following as examples of structured financial instruments that may be assumed to embed a FDI:

- credit linked notes;
- convertible or exchangeable bonds;
- structured financial instruments whose performance is linked to the performance of, for example, a basket of shares or a bond index, or structured financial instruments with a nominal fully guaranteed whose performance is linked to the performance of a basket of shares with or without active management;

- collateralised debt obligations and asset backed securities that create leverage, i.e. the CDO is not a limited recourse vehicle and the investors' loss can be higher than their initial investment or are not sufficiently diversified.

UCITS must also understand that if they use structured financial instruments they must embed FDI, they must respect the principles of the UCITS Regulations. It is the responsibility of the UCITS to check that investment in hybrid instruments embedding derivatives complies with the requirement whether the nature, frequency and scope of checks which the UCITS should perform will depend on the characteristics of the embedded derivatives and their impact on the UCITS, taking into account its stated investment objective and risk profile.

## 9.16 UCITS investment in total return swaps

Specific rules also apply where a UCITS enters into a total return swap or in other financial instruments with similar characteristics. In this case, the assets held by the UCITS must comply with the risk diversification limits set out in Regulations 70-74 of the UCITS Regulations. In addition, the UCITS Prospectus must disclose:

- (i) information on the underlying strategy or index and composition of the investment portfolio or index;
- (ii) information on the counterparty(ies) to the transactions;
- (iii) a description of the risk of counterparty default and the effect on investor returns; and
- (iv) details on the extent to which the counterparty assumes any discretion over the composition or management of the UCITS investment portfolio or over the underlying of the financial derivative instruments, and whether the approval of the counterparty is required in relation to any UCITS investment portfolio transaction.

## 9.17 Annual FDI Report

A UCITS is required to submit an annual report to the Central Bank on its derivative positions (an “**Annual FDI Report**”) so that the Central Bank may review the use of derivatives and any breaches of risk.

As set out in Guidance Note 3/03, the Annual FDI Report should include details of the following:

- (i) summary review on the use of derivatives by the UCITS during the year (see also para 20 of UCITS Notice 10);
- (ii) instances of any breaches of global exposure or of counterparty risk exposure;
- (iii) where relevant, a summary of non-material updates to the RMP (a revised RMP should be attached).

In the case of UCITS using VaR, the Annual FDI Report must include the following additional information:

- (a) year-end VaR number expressed as a percentage of NAV (where applicable);
- (b) instances of any breaches in VaR limits during the year, with an explanation of remedial action and duration of breach;
- (c) confirmation as to whether back-testing has been successful in accordance with the requirements and, if not, what actions the UCITS has taken to address the situation;
- (d) confirmation that the UCITS does have a stress testing regime, an overview of the broad assumptions behind such testing and a commentary on the results of the stress testing and its applicability to the day to day use of the model.

## 10. UCITS investing in Financial Indices

As noted in earlier chapters, the original UCITS Directive's "5/10/40" rule made it difficult for UCITS to replicate or even track certain indices. Far more flexibility is now permitted, not only by allowing index trackers have higher exposures (ie. the 20%/35% rule) but also by allowing UCITS take exposures to financial indices via derivatives.

We now have UCITS index trackers or replicators and UCITS ETFs, which have been addressed in earlier Chapters, as well as UCITS which take exposures to financial indices as the underlying of financial derivative instruments. This Chapter addresses that type of exposure principally and, in particular, the relatively new additional rules found in ESMA's "*Guidelines on ETFs and other UCITS issues*" and which are reflected in Central Bank UCITS Notice 21.

ESMA's new requirements relating to "financial indices" apply not only to where such indices are the underlying of derivatives but also where UCITS seek to utilise the 20%/35% rule to track or replicate an index by means of direct investment.

### 10.1 Preliminary

At the outset, it should be noted that, following submissions made to the Central Bank, the new rules relating to financial indices do not apply when a UCITS which invests in financial indices (via an index tracker or via financial derivative instruments) can apply a "look through" approach. In other words, where it would be possible for the UCITS to directly invest in the constituents of the index such that the constituents of the index, when consolidated with the assets held directly by the UCITS, meet the standard 5/10/40 requirements.

The rules in relation to financial indices also do not apply when a UCITS only uses a financial index as a performance benchmark.

### 10.2 Disclose use of Limits

When a UCITS intends to make use of the increased 20%/35% diversification limits, that must be disclosed clearly in the prospectus, together with a description of the exceptional market conditions which justify such investment.

### 10.3 Diversification Limit

A UCITS may not invest in a financial index which has a single component that has an impact on the overall index return which exceeds the diversification requirements applicable to an index tracker (i.e. 20%/35%).

In the case of a leveraged index, the impact of one component on the overall return of the index, after having taken into account the leverage, must also respect that diversification requirement.

## 10.4 Index criteria

In its Guidelines referenced above, ESMA has set out a series of rules regarding the financial indices that a UCITS may invest in. Those rules are, in summary, as follows:

- (i) *Single Commodity Indices:* Single commodity indices are not permissible. Sub-categories of the same commodity should be considered as being the same commodity for the calculation of the diversification limits (for example, WTI Crude Oil, Brent Crude Oil, Gasoline or Heating Oil contracts should be considered as being all sub-categories of the same commodity – oil). However, sub-categories of a commodity should not be considered as being the same commodity, if they are not highly correlated.
- (ii) *Adequate benchmark:* A UCITS must be able to demonstrate that an index satisfies certain criteria, including that of being a benchmark for the market to which it refers. For that purpose: (a) an index should have a clear, single objective in order to represent an adequate benchmark for the market (b) the methodology used for the selection of the index components should be clear and (c) any cash management element should not affect the objective nature of the index calculation methodology.
- (iii) *Bespoke Indices:* An index will not be eligible if it has been created and calculated on the request of one, or a very limited number of, market participants and according to the specifications of those market participants.
- (iv) *Rebalancing Frequency:* The rebalancing frequency of the index (which must be disclosed in the Prospectus) must not prevent investors from being able to replicate the index (indices which rebalance on an intraday or daily basis do not satisfy this criterion). It should be noted that technical adjustments made to financial indices (i.e. adjustments which are based solely on algorithmic non-subjective frameworks, are generally published on an ex-ante basis, draw on publicly available criteria and do not rely on the judgement of the index provider) are not considered as rebalancing in this context.
- (v) *Calculation methodology:* The full calculation methodology of the index (including the provision of detailed information on index constituents, index calculation, re-balancing

methodologies, index changes and information on any operational difficulties in providing timely or accurate information) must be disclosed by the index provider and be easily accessible (for example, via the internet), free of charge, by investors and prospective investors. Investors should also have free access to information on the performance of the index.

- (vi) *Predetermined rules / objective criteria:* The methodology for the selection and the rebalancing of the components of the index must be based on a set of predetermined rules and objective criteria. Such methodology must not permit retrospective changes to previously published index values ('backfilling'). Further, a UCITS may not invest in financial indices whose index provider accepts payments from potential index components for inclusion in the index.
- (vii) *Publication of constituents and weightings:* The constituents of the index together with their respective weightings must be published. This information should be easily accessible, free of charge, by investors and prospective investors, for example, via the internet. Weightings may be published after each re-balancing on a retrospective basis (for example, if an index rebalances on a monthly basis, information on the weightings of the index components should be provided as soon as possible after the rebalancing but within one month of the rebalancing). This information should cover the previous period since the last rebalancing and include all levels of the index (i.e. if a financial index is comprised of other financial indices, the transparency requirements also apply to the underlying indices).
- (viii) *Independent valuation:* The financial index must be subject to independent valuation. Note that if the valuation is performed by the index provider itself, then the unit in charge of the valuation must be functionally independent from the unit responsible for the design of the index and the UCITS itself must carry out its own due diligence. Also, the remuneration of the staff responsible for the valuation of the index should not be linked to the performance of the index.

## 10.5 Due Diligence by UCITS

In addition to the requirements listed above, a UCITS must carry out appropriate, documented due diligence on the quality of the index which should take into account whether the index methodology contains an adequate explanation of the weightings and classification of the components on the basis of the investment strategy and whether the index represents an adequate benchmark.

The UCITS should also assess the availability of information on the index including:

- (i) whether there is a clear narrative description of the benchmark;

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- (ii) whether there is an independent audit and the scope of such an audit; and
- (iii) the frequency of index publication and whether this will affect the ability of the UCITS to calculate its net asset value.

## 11. Available Legal Structures

We have previously described the various rules which relate to the UCITS product and what it can invest in. Those rules apply across the European Union.

In this Chapter we explain the different legal structures in Ireland which can be used to house UCITS, namely, the two corporate structures (the ICAV and the VCC), unit trusts and common contractual funds. There is, in fact, a further corporate fixed capital company which is not, in practice, ever used.

Although they are each quite different legal structures, it is important to remember that:

- each remains subject to the very same UCITS investment, borrowing and leverage rules;
- as UCITS, each must have as its sole object the collective investment in either or both transferable securities and other liquid financial assets of capital raised from the public and based on the principle of risk spreading and provide for at least fortnightly redemption facilities;
- unit trusts and CCFs need a UCITS Management Company in the structure, whereas the ICAVs and VCCs do not (but can have, if they want);
- each must have an Irish based Trustee/Custodian responsible for safekeeping of assets and performance of certain fiduciary type duties (will become the “Depository” under UCITS V);
- most UCITS (or their ManCo’s) will appoint an Investment Manager responsible for discretionary asset management of the UCITS portfolio and many will appoint a Global Distributor or local Distributors. Typically, the administration function (calculation of the NAV, the accounting function, maintenance of books and records and the transfer agency function) is carried out by an Irish administrator although, under UCITS IV, there is now scope for such services to be passported into Ireland (please refer to the following Chapter, which sets out further information with regard to the Management Company passport).

Notwithstanding the above, there are quite a number of distinctions between the four legal structures as summarised below.

## 11.1 ICAVs

The most recent addition to the menu of available Irish legal structures – and likely to become the most popular choice of structure – is the Irish collective asset-management vehicle (the “**ICAV**”). This is a corporate type fund which is governed by a very specific and bespoke piece of legislation, the Irish Collective Asset- management Vehicles Act 2015 (the “**ICAV Act**”). Although an ICAV is a corporate fund, it is not a public limited company (“**PLC**”) and therefore is not subject to normal Irish company law which applies to Irish trading companies and to UCITS VCCs.

### (i) *Unique ICAV Features*

Because it is subject to its own bespoke ICAV Act, the ICAV offers many operational efficiencies which normal corporates or VCCs cannot offer, including that:

- amendments to its Instrument of Incorporation can be implemented without the need for proposed amendments to be sanctioned by the shareholders, provided that the Custodian of the ICAV certifies that the proposed amendments will not prejudice the interests of the shareholders;
- the requirement to hold an annual general meeting may be avoided by giving at least sixty days’ written notice to all of the ICAV’s shareholders;
- financial statements may be published on a sub-fund by sub-fund basis in the case of an umbrella ICAV. In the case of the other UCITS corporate fund, the VCC, Irish company law requires the accounts of all sub-funds of an umbrella VCC to be included in the financial statements of that company;
- the ICAV is subject to a more simplified procedure for facilitating schemes of amalgamation, mergers, divisions and other general reorganisations;
- in addition to the above features, it is possible for existing Irish VCCs to convert to an ICAV; and
- funds domiciled outside of Ireland can re-domicile into Ireland by continuation as ICAVs.

(ii) *Check-the-box*

An ICAV can be structured so that it can “check-the-box” to be treated as a partnership or disregarded entity for US federal tax purposes. Therefore, an ICAV can facilitate investment by US taxable investors and/or US taxable and tax-exempt investors in a master feeder fund structure.

This is distinct from the treatment of UCITS VCCs, which cannot check-the-box to be a flow-through for US tax purposes.

(iii) *Other Distinguishing ICAV Features*

While an ICAV issues shares to investors and has some other common features with VCCs, the following features further distinguish it from the VCC structure:

- (a) incorporation is effected by the filing of certain prescribed documents with the Central Bank (not the Irish Companies Registration Office which is the registry applicable to a VCC);
- (b) the constitutive document of the ICAV is the Instrument of Incorporation, not a Memorandum and Articles of Association;
- (c) unlike VCCs, there is no statutory requirement to diversify investment risk in the case of an ICAV.

(iv) *Minimum Paid-up Capital for Self-Managed ICAVs*

As in the case of self-managed VCCs, self-managed ICAVs require a minimum paid up capital of Euro 300,000 before commencing operations and are also subject to the two Irish directors and “anti-letterbox” requirements applicable to Management Companies (as further set out in the Chapter relating to UCITS Management Companies).

If an ICAV has a UCITS Management Company, then the Euro 300,000 capital requirement does not apply. The UCITS Management Company has its own capital requirements instead.

(v) *Contracts*

ICAVs enter into contracts themselves as corporate entities, principally with the Investment Manager, Administrator and Distributor (or via the Management Company if not self-managed) and with the Custodian. ICAVs which use a Management Company do not need to meet the “anti-letterbox” or capital adequacy requirements for self-managed ICAVs.

(vi) *Umbrella ICAVs*

ICAVs can be established as umbrella schemes. Just like VCCs, umbrella ICAVs benefit from specific statutory provisions dealing with segregated liability between sub-funds.

## 11.2 UCITS variable capital investment companies

UCITS variable capital investment companies or “**VCCs**” are public limited liability corporate vehicles with their own legal personality. In addition to the UCITS Regulations they are subject to Irish company law (with relevant exceptions) as it applies to public limited companies.

Their constitutive document is the Memorandum and Articles of Association and ultimate management authority resides with a board of directors, two of whom must be Irish resident. VCCs issue shares to investors which shares do not represent a legal or beneficial interest in the VCCs assets, those assets being legally held by the Custodian, beneficially by the VCC itself. Unlike both unit trusts and CCFs, VCCs are required to convene and hold an annual general meeting of shareholders and any changes to their Memorandum and Articles of Association require investor approval.

Self-managed VCCs require a minimum paid up capital of Euro 300,000 before commencing operations and are also subject to the “anti-letterbox” requirements applicable to Management Companies (as further set out in the Chapter relating to UCITS Management Companies).

VCCs enter into contracts themselves as corporate entities, principally with the Investment Manager, Administrator and Distributor (or via the Management Company if not self-managed) and with the Custodian. VCCs who use a Management Company do not need to meet the capital adequacy requirements for self-managed investment companies.

VCCs can be established as umbrella schemes and umbrella VCCs benefit from specific statutory provisions dealing with segregated liability between sub-funds.

## 11.3 UCITS unit trusts

Unit trusts are contractual arrangements created under a deed of trust (the “trust deed”) made between the Management Company and the Trustee.

Unlike VCCs and ICAVs, unit trusts do not have their own legal personality. Contracts are entered into in respect of unit trusts by the Management Company and, in certain cases, by the Trustee. The ultimate management authority rests with the UCITS Management Company which can act as

Management Company for multiple collective investment schemes (UCITS and Non-UCITS; VCCs, ICAVs, unit trusts and CCFs).

The UCITS Management Company must itself be authorised separately to the unit trust's own UCITS authorisation and it must meet the "anti-letterbox" and capital adequacy requirements (as further set out in the Chapter relating to UCITS Management Companies).

Unit trusts issue units to investors where a unit represents an undivided beneficial interest in the assets of the unit trust. The assets are legally held by the Trustee.

Unit trusts are not required to hold annual investor meetings and, provided both the Management Company and Trustee certify that such changes do not prejudice the interests of investors, changes can be made to the trust deed without having to obtain prior investor approval.

## 11.4 UCITS Common Contractual Fund

The common contractual fund or **CCF** is a contractual arrangement similar to the FCP (fonds commun de placement) structures in other European jurisdictions (notably Luxembourg and France, and the Dutch FGR (fonds voor gemene rekening)) enabling the assets held on behalf of investors to be managed through a single pool in proportion to the assets or cash subscribed to the pool.

A CCF is constituted under contract law by means of a deed of constitution executed under seal by the Management Company. The deed provides for the safekeeping of assets of the CCF by a Custodian - who is also a party to the deed – and specifies the fiduciary responsibilities of the Custodian which are equivalent to those of custodians/trustees of other UCITS schemes. The deed also provides that the Custodian will be appointed on the terms of a custodian agreement to be entered into by the Management Company and Custodian. Importantly, the CCF is an unincorporated body and does not have legal personality. Because a CCF does not have legal personality, it may act only through the Management Company (or investment manager, if authority is delegated to an investment manager).

Participants in the CCF hold their participation as co-owners and each participant holds an undivided co-ownership interest as a "tenant in common" with other participants. A "tenancy in common" is a form of co-ownership in which the joint owner (the "tenant in common") has a distinct but undivided interest or share in the property the subject of the co-ownership but with no right of survivorship (e.g. on death of one co-owner) in favour of any of the other joint owners (tenants in common). Investors do not have any beneficial entitlement to any particular asset. Instead, they have a proportional beneficial entitlement to an interest in the underlying pool of assets.

To assist in achieving tax transparency (these characteristics differentiate a CCF from an opaque corporate body), a CCF will normally have the following additional characteristics:

- (i) income derived through the pooling vehicle should be distributed on a mandatory basis annually, pro rata to each participant's investment in the CCF. This ensures that the income is both accounted for and taxed on an "arising"/ current basis;
- (ii) the CCF participant should be provided with an annual breakdown of income on investments by type and source;
- (iii) no redemption charge should be levied on participants;
- (iv) no "investor" meetings (i.e. meetings similar to shareholder meetings) should be permitted;
- (v) the Irish tax authorities must view a CCF as a transparent vehicle for Irish tax purposes;
- (vi) holdings/units in a CCF should not be freely transferable but are redeemable. It has, however, been accepted that units may be transferred in limited circumstances, i.e. with the prior consent of 100% of unitholders and the Management Company; and
- (vii) assets should be jointly held by participants pro-rata to their investment.

## 11.5 Umbrellas, Sub-Funds and Classes

Whichever legal structure is chosen, UCITS can be established as single *stand-alone* funds and as *umbrella* funds, and can offer different unit or share classes within a fund, the normal differentiating factors being target audience (retail, professional, institutional), minimum subscription/holding requirements, designated currency and fees.

It is a fundamental principle, however, that assets/liabilities within a single fund are not allocated to individual classes, but may be "attributable" to classes in certain cases, such as in the case of hedged currency classes where the gains/losses are attributed to the relevant classes, as well as other class liabilities such as fees.

The Central Bank has in the past permitted financial derivative instruments to be used at share class level to provide:

- (i) interest rate hedging at share class level;
- (ii) a different level of participation in the performance of the underlying portfolio; or

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- (iii) different levels of capital protection, subject to and in accordance with the requirements of the Central Bank as set out in the Central Bank Policy Update – 1 / 2010.

Readers should note that we await the outcome of the review triggered by ESMA's December 2014 Discussion Paper relating to "Share Classes of UCITS". The extent to which share classes can be used in the circumstances set out at (i) – (iii) above is under review and is the subject of ongoing consultation with ESMA.

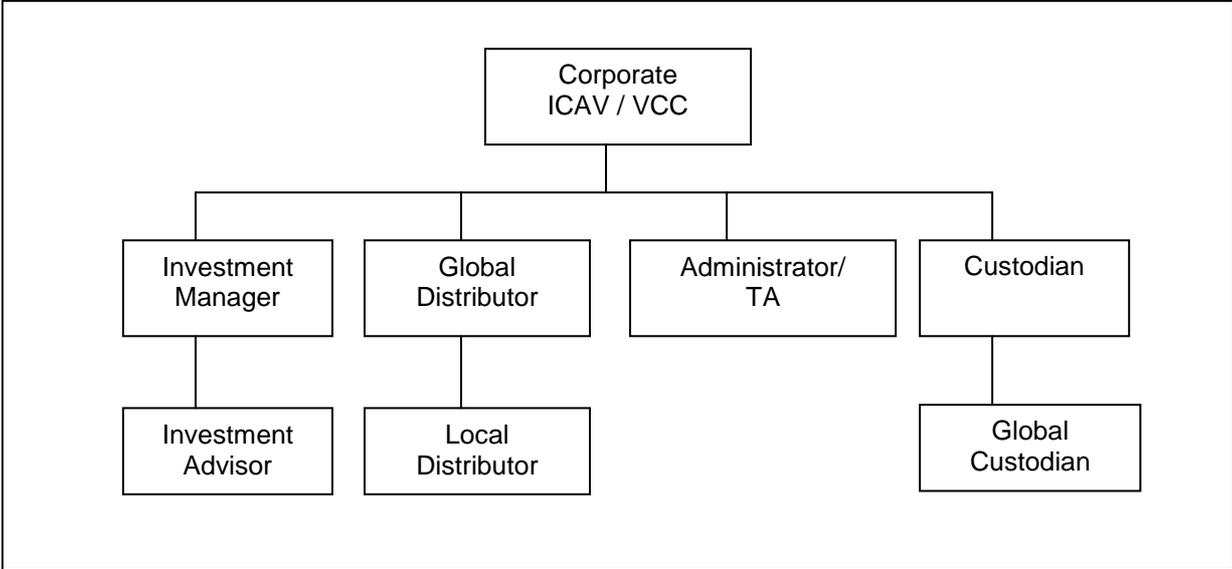
## 11.6 Umbrellas, Sub-Funds and Classes

We have given 4 slightly different structure charts below. The first two deal with corporate funds and apply equally whether the corporate fund is an ICAV or VCC.

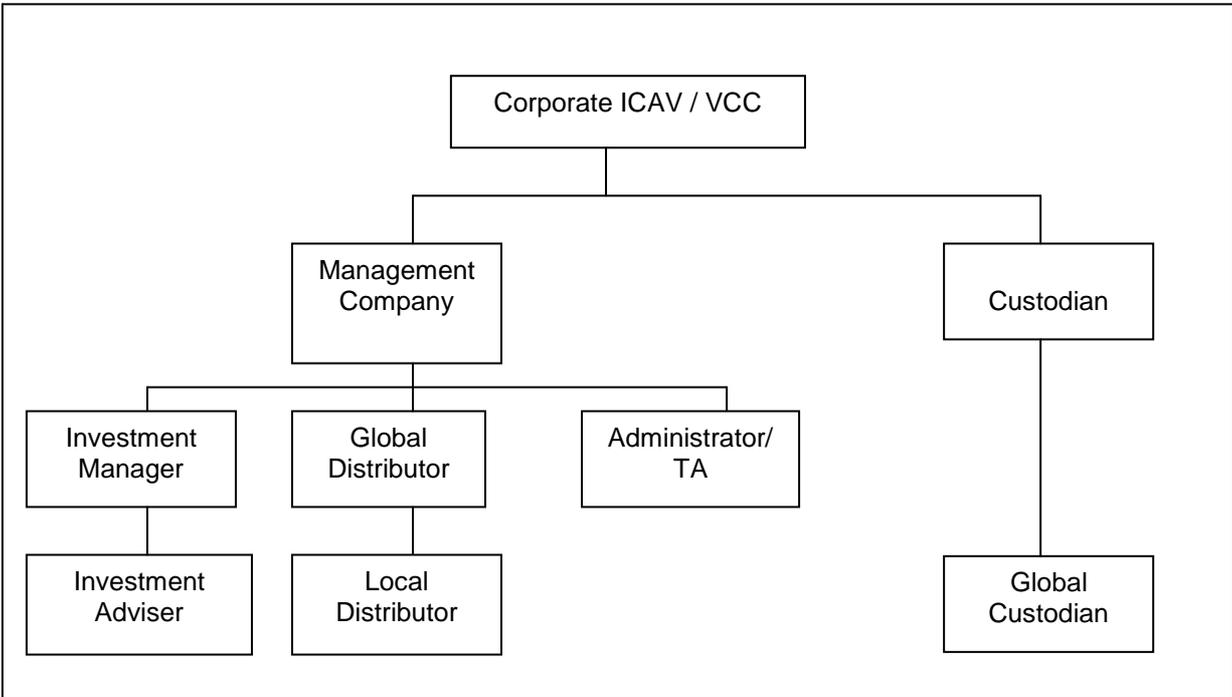
Box 1 is for a self-managed (ie. no UCITS ManCo) ICAV or VCC, whereas Box 2 is for a corporate fund which has a UCITS ManCo.

Boxes 3 and 4 are for unit trusts and CCFs, respectively.

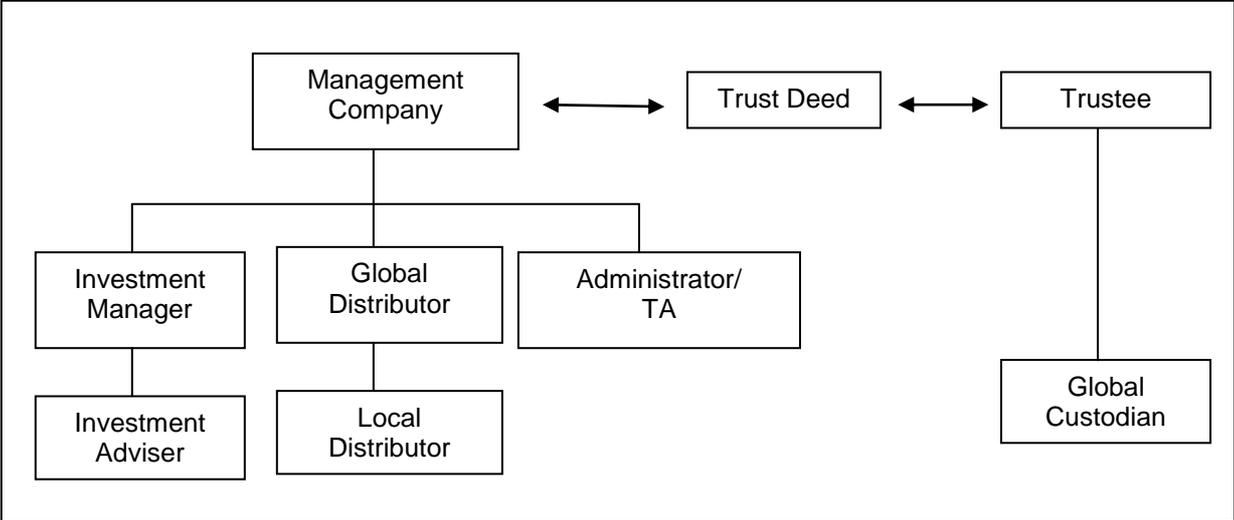
Box 1 – Self Managed UCITS ICAV / VCC



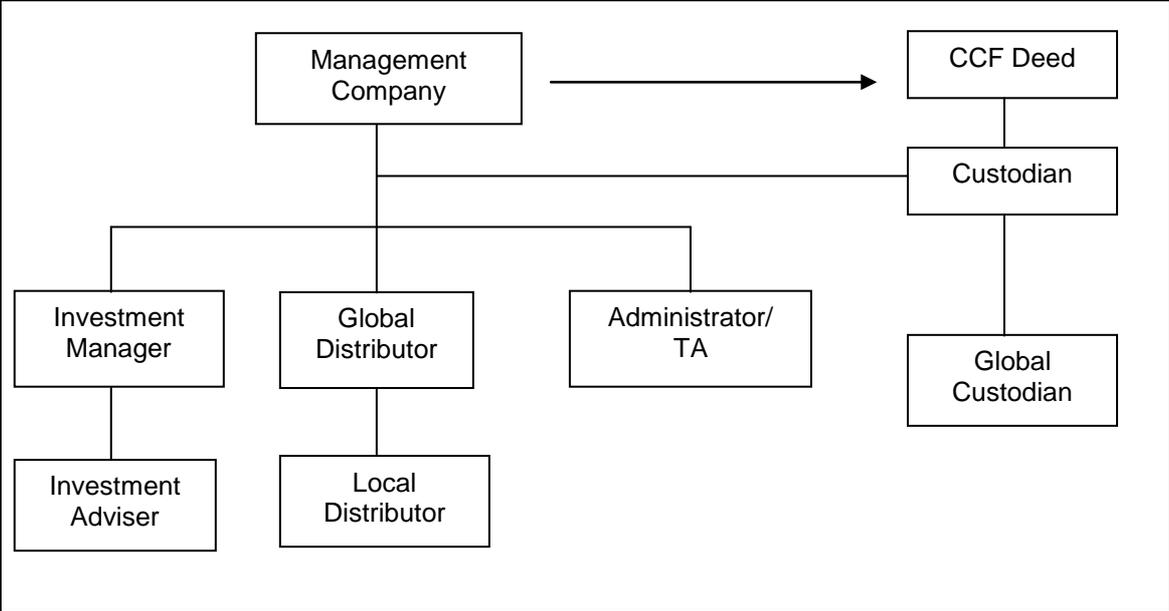
Box 2 – UCITS Corporate ICAV / VCC with Irish Management Company



Box 3 – UCITS Unit Trust



Box 4 – UCITS Common Contractual Fund (CCF)





## 12. The Prospectus

A UCITS must publish a prospectus which must be dated and the essential elements of which must be kept up to date. The prospectus must address the general and the specific content requirements of UCITS Notice 6 which, for ease of reference, we set out in full below.

In practice UCITS prospectuses follow a relatively standard order, usually with individual supplements for specific sub-funds. This makes subsequent sub-fund launches generally more efficient by only having to submit a new supplement to the Central Bank for review, rather than the entire prospectus. Much negotiation may be held with the Central Bank regarding the UCITS prospectus disclosure of investment objectives, investment strategies and the nature and type of investments and leverage to be employed.

### 12.1 Format

The prospectus can be provided in a durable medium or by means of a website and a paper copy must be delivered to investors free of charge on request. Where a prospectus is provided using a durable medium the conditions set out in Article 38 of Commission Regulation 583/2010 apply.

It can also be translated into other languages provided that any such translations shall only contain the same information and shall have the same meaning as in the prospectus submitted to the Central Bank

### 12.2 Content

The prospectus must contain sufficient information for investors to make an informed judgement of the investment proposed to them and in particular of the risks attached to that investment. It must include a clear and easily understandable explanation of the UCITS risk profile and any material changes to the content of the prospectus must be notified to investors in the next periodic report.

It must contain at least the following information:

- (i) *Information concerning the UCITS*
  - (a) Name, form in law, and, if applicable, registered office and head office if different from the registered office.
  - (b) Identity and brief details of the financial group promoting the UCITS.

- (c) Date of establishment or incorporation of the UCITS and indication of duration, if limited.
- (d) Statement of the place where the trust deed, the deed of constitution or the articles of association, if not annexed and periodic reports may be obtained, free of charge.
- (e) Brief indications relevant to unitholders of the tax system applicable to the UCITS. Details of whether deductions are made at source from the income and capital gains paid by the UCITS to unitholders.
- (f) Accounting and distribution dates. The time limit (if any) after which entitlement to dividend lapses and procedure in this event.
- (g) Name and address of auditor.
- (h) In the case of investment companies:
  - names and positions in the company of the directors. Their experience both current and past, which is relevant to the UCITS. Details of their main activities outside the company where these are of significance with respect to that company.
  - authorised share capital.
- (i) Details of the types and main characteristics of the units and in particular:
  - the nature of the right (real, personal or other) represented by the unit;
  - original securities or certificates providing evidence of title, entry in a register or in an account;
  - characteristics of the units, registered or bearer. Indication of any denominations which may be provided for;
  - indication of unitholders' voting rights;
  - circumstances in which winding-up of the UCITS can be decided on and winding-up procedure, in particular as regards the rights of unitholders.
- (j) Where applicable, indication of stock exchanges or markets where the units of the UCITS are listed or dealt in.

- (k) Procedures and conditions of issue and sale of units.
- (l) Procedures and conditions for repurchase or redemption of units, including the period within which redemption proceeds will normally be paid or discharged to investors. Circumstances in which repurchase or redemption may be temporarily suspended
- (m) Description of rules for determining and applying income.
- (n) Information concerning the arrangements for making payments to unitholders, purchasing or redeeming units and making available information concerning the UCITS.
- (o) Description of the UCITS investment objectives (e.g. capital growth or income) and investment policy (e.g. specialisation in geographical or industrial sectors).

The description must be comprehensive and accurate, readily comprehensible to investors and sufficient to enable investors make an informed judgement on the investment proposed to them. The description should include any limitations on that investment policy, and borrowing powers which may be used in the management of the UCITS.

- (p) Description of the UCITS intentions regarding techniques and instruments which may be used for the purposes of efficient portfolio management, in accordance with Notice UCITS 12 and Guidance Note 3/03. This should include reference to the techniques and instruments which the UCITS can utilise and a detailed description of the inherent risks, including counterparty risk and potential conflicts of interest that may arise. Disclosure should also include:
  - (i) information on the impact of efficient portfolio management techniques on the performance of the UCITS; and
  - (ii) policy regarding direct and indirect operational costs and fees arising in the context of these techniques, in accordance with paragraph 19 of Notice UCITS 12.
- (q) Clear information on the collateral policy of the UCITS arising from OTC derivative transactions or efficient portfolio management techniques. Disclosure should include permitted types of collateral, level of collateral required and haircut policy and, in the case of cash collateral, re-investment policy (including the risks arising from the re-investment policy).
- (r) A statement that the UCITS will, on request, provide supplementary information to unitholders relating to the risk management methods employed, including the quantitative

limits that are applied and any recent developments in the risk and yield characteristics of the main categories of investments

- (s) Rules for the valuation of assets.
- (t) Determination of the sale or issue price and the repurchase or redemption price of units, in particular:
  - the method and frequency of the calculation of those prices;
  - information concerning the charges relating to the sale or issue and the repurchase, or redemption of units;
  - the means, places and frequency of the publication of those prices.
- (u) In the case of umbrella UCITS:
  - the charges, if any, applicable to switching of investments from one sub-fund to another;
  - the extent to which one sub-fund can invest in another and the conditions which apply to such investments.
- (v) The manner, amount and calculation of remuneration payable by the UCITS to the management company, directors of the investment company, the trustee or third parties, and reimbursement of costs by the scheme to the management company, directors of the investment company, the trustee or to third parties. All other costs and expenses which will be borne by the UCITS, including costs of establishment.

All information on remuneration, costs and expenses to be borne by the UCITS must be contained in the same section of the prospectus and in a form that can be easily understood and analysed.
- (w) Investment companies within the meaning of UCITS Regulation 49(1) shall also indicate;
  - the method and frequency of calculation of the net asset value of units;
  - the means, place and frequency of the publication of the value;

- the stock exchange in the country of marketing the price on which determines the price of transactions effected outside stock exchanges in that country.
- (x) Profile of the typical investor for whom the UCITS is designed.
- (ii) *Information Concerning a Management Company*
  - (a) Name, form in law, registered office and head office if different from the registered office. If the company is part of a group, the name of that group and the ultimate parent. Date of incorporation of the company and indication of duration if limited.
  - (b) If the company manages other collective investment schemes, indication of those other schemes.
  - (c) Names and positions in the company of the members of the administrative, management and supervisory bodies. Their experience, both current and past, which is relevant to the scheme. Details of their main activities outside the company where those are of significance with respect to that company.
  - (d) Amount of the prescribed capital with an indication of the capital paid-up.
- (iii) *Information Concerning a Trustee*
  - (a) Name, form in law, registered office and head office if different from the registered office.
  - (b) Main activity.
- (iv) *Information Concerning Investment Advisers*

Information concerning the advisory firms or external investment advisers who give advice under contract which is paid for out of the assets of the UCITS.

- (a) Name of the firm or adviser.
- (b) Material provisions of the contract with the management company or investment company which may be relevant to the unitholders, excluding those relating to remuneration.
- (c) Other significant activities
- (v) *General Information*

- (a) The prospectus must state that the authorisation of the UCITS is not an endorsement or guarantee of the UCITS by the Central Bank nor is the Central Bank responsible for the contents of the prospectus and must incorporate the following statement:

*“The authorisation of this UCITS by the Central Bank shall not constitute a warranty as to the performance of the UCITS and the Central Bank shall not be liable for the performance or default of the UCITS.”*

- (b) The prospectus must identify, and describe in a comprehensive manner, the risks applicable to investing in that particular UCITS. In particular the prospectus should make reference to:
- the fact that prices of units may fall as well as rise;
  - the desirability of consulting a stockbroker or financial adviser about the contents of the prospectus; and
  - where relevant, the fact that the difference at any one time between the sale and repurchase price of units in the UCITS means that the investment should be viewed as medium to long term.
  - Details of the persons who accept responsibility for information contained in the prospectus.
  - In the event that a stated minimum viable size is not reached within a specified period the prospectus must state that the UCITS will return any subscriptions to the unitholders and apply to the Central Bank for revocation of its authorisation.
  - A description of the potential conflicts of interest which could arise between the management company, investment adviser and the UCITS, with details, where applicable, of how these are going to be resolved.
  - A description of soft commission arrangements which may be entered into by a management/administration company of a UCITS.
  - The name of any third party which has been contracted by the management company or investment company to carry out its work.

- Material provisions of the contracts between third parties and the management company or investment company which may be relevant to unitholders, excluding those relating to remuneration.

### 12.3 Additional Information Requirements for Specific UCITS

UCITS with investment objectives which involve a higher than average degree of risk (e.g. UCITS investing in emerging markets or in warrants) must recommend that an investment in the UCITS should not constitute a substantial proportion of an investment portfolio and may not be appropriate for all investors. This warning must be inserted and highlighted at the beginning of the prospectus and the prospectus must contain a full description of the risks involved.

Where the net asset value of a UCITS is likely to have a high volatility due to its portfolio composition or the portfolio management techniques that may be used, a prominent statement drawing attention to this characteristic must be included in the prospectus.

The prospectus must provide additional disclosure if the UCITS falls under the following categories:

### 12.4 UCITS which use FDIs

A UCITS which may engage in transactions in FDI must include a prominent statement to this effect, which will indicate if FDI may be used for investment purposes and/or solely for the purposes of hedging. This statement must also indicate the expected effect of FDI transactions on the risk profile of the UCITS. A description of the permitted types of FDI and the extent to which the UCITS may be leveraged must be provided.

Where a UCITS will invest principally in FDI, it must insert a warning of this intention at the beginning of the prospectus and any other promotional literature.

UCITS must disclose the method used to calculate global exposure (i.e. commitment approach, relative VaR or absolute VaR).

UCITS using VaR approaches must disclose the expected level of leverage and the possibility of higher leverage levels. Leverage should be calculated as the sum of the notionals of the derivatives used. This may be supplemented with leverage calculated on the basis of a commitment approach. The creation of leveraged exposure to an index via FDI, or the inclusion of a leverage feature in an index, must also be taken into account in meeting the prospectus disclosure requirements.

When using the relative VaR approach, information on the reference portfolio must be disclosed.

A UCITS using total return swaps, or other financial derivative instruments with the same characteristics, should include the following:

- (i) Information on the underlying strategy or index and composition of the investment portfolio or index;
- (ii) information on the counterparty(ies) to the transactions;
- (iii) a description of the risk of counterparty default and the effect on investor returns; and
- (iv) details on the extent to which the counterparty assumes any discretion over the composition or management of the UCITS investment portfolio or over the underlying of the financial derivative instruments, and whether the approval of the counterparty is required in relation to any UCITS investment portfolio transaction.

Where the counterparty has discretion over the composition or management of the UCITS investment portfolio or of the underlying of the financial derivative instrument, the agreement between the UCITS and the counterparty should be considered as an investment management delegation arrangement and should comply with the UCITS requirements on delegation. In this case the prospectus must identify the counterparty as an investment manager.

## 12.5 Funds of Funds

A UCITS which may invest more than 20% of its assets in other CIS must include a prominent statement to this effect in the prospectus and in any promotional literature which it issues. The prospectus must disclose the maximum level of management fees that may be charged to the CIS in which it invests.

## 12.6 Cash / Money Market Funds

A UCITS which may invest substantially in deposits or money market instruments must provide a risk warning drawing attention to the difference between the nature of a deposit and the nature of an investment in the UCITS, with particular reference to the risk that the principal invested in the UCITS is capable of fluctuation.

A UCITS which may invest substantially in deposits with credit institutions must include a prominent statement to this effect in the prospectus and in any promotional literature which it issues.

## 12.7 Index-Tracking Funds

A UCITS which replicates a stock or debt securities index must include a prominent statement to this effect in the prospectus and any other promotional literature

The prospectus of an index-tracking UCITS should include:

- (i) a clear description of the index including information on the underlying components or details of the website where the exact composition of the index is published;
- (ii) information on how the index will be tracked (for example, whether it will follow a full or sample based physical replication model or a synthetic replication) and the implications of the chosen method for unitholders in terms of their exposure to the underlying index and counterparty risk;
- (iii) information on the anticipated level of tracking error in normal market conditions;
- (iv) a description of factors that are likely to affect the ability of the UCITS to track the performance of the index, such as transaction costs, small illiquid components or dividend re-investments.

## 12.8 Index Tracking Leveraged Funds

The prospectus for an index-tracking leveraged UCITS should include the following information:

- (i) a description of the leverage policy, how this is achieved (i.e. whether the leverage is at the level of the index or arises from the way in which the UCITS obtains exposure to the index), the cost of the leverage (where relevant) and the risks associated with this policy;
- (ii) a description of the impact of any reverse leverage (i.e. short exposure);
- (iii) a description of how the performance of the UCITS may differ significantly from the multiple of the index performance over the medium to the long term.

## 12.9 Structured UCITS

A structured UCITS, as defined in Article 36(1) of Commission Regulation No 583/2010, must ensure that the prospectus:

- (i) contains full disclosure regarding the investment policy, underlying exposure and payoff formulas in clear language which can be easily understood by the retail investor; and
- (ii) includes a prominent risk warning informing investors who redeem their investment prior to maturity that they do not benefit from the pre-defined payoff and may suffer significant losses.

## 13. Key Investor Information Document

In addition to preparing and issuing a full prospectus which often runs to many pages, particularly for umbrella schemes, under UCITS IV, each UCITS is required to prepare a Key Investor Information Document (“**KIID**”). The KIID is required to be a short and concise document containing information so as to enable investors better understand the investment product being offered. The KIID replaces the simplified prospectus which is widely considered to have failed to achieve its objectives.

### 13.1 General Rules

The following are the general rules which apply to the KIID:

- (i) the KIID must be fair, clear and not misleading;
- (ii) the KIID must be written in a concise manner and in non-technical language;
- (iii) the KIID must not exceed two pages of A4 – sized paper when printed (or three pages in the context of a structured UCITS);
- (iv) the KIID must include appropriate information about the essential characteristics of the UCITS as outlined below, which is to be provided to investors so that they are reasonably able to understand the nature and the risks of the investment product that is being offered to them and consequently to take investment decisions on an informed basis;
- (v) the essential elements of the KIID must be kept up-to-date;
- (vi) the contents of the KIID must constitute pre-contractual information.

### 13.2 Preparation of the KIID

The KIID can only contain the information specified in the UCITS Regulations, Commission Regulation (EU) No 583/2010 (Key Investor Information and Conditions to be met when providing Key Investor Information or the Prospectus in a durable medium other than paper or by means of a website) (the “Commission Regulation”) and must be prepared in accordance with the template produced by ESMA (the “ESMA Template”).

This information includes:

- (i) objectives and investment policy

- (ii) risk and reward profile
- (iii) charges for this fund
- (iv) past performance
- (v) practical information

The presentation of the information in the KIID must follow the same order as above and the headings in the KIID must be consistent. This is to facilitate investors drawing comparisons with other UCITS.

### 13.3 Application of the KIID to sub-funds and share classes

An umbrella UCITS must publish a separate KIID for each sub-fund. Alternatively, a KIID may be published for individual share classes within a UCITS or within a sub-fund of an umbrella UCITS. However, there is no requirement to produce a KIID per share class. This is important to note as producing KIIDs on a share class level may be more costly and time consuming.

The UCITS may decide to select a share class to represent one or more other classes of the UCITS and as such certain conditions apply where a representative share class has been selected. For example, where fees differ between share classes, the Central Bank considers the share class with the highest overall charge to be the most appropriate representative share class, to avoid the risk of understating charges or overstating performance.

### 13.4 Presentation and Language

The KIID must be presented and laid out in such a way that it is easy to read and written in a language that facilitates the investor's understanding of the information being communicated. While the KIID must comply with the requirements of the UCITS Regulations, the Commission Regulation and must be drafted in accordance with ESMA's *Guide to Clear Language and Layout* ("CESR/10 – 1320), it is the responsibility of the UCITS to write and design the KIID in such a way as to make it comprehensible for investors.

The KIID may cross refer to information contained in the UCITS prospectus which may be useful to the investor but should avoid cross referring to such a degree that comprehension of the essential information is not possible.

In addition, while branding of the KIID is permitted it should not distract the reader or obstruct text required by the template.

## 13.5 Individual sections of the KIID

Turning to the individual sections of the KIID, see more detail below.

### (i) *Objectives and investment policy*

The investment objective must be clearly stated so that potential investors can easily see whether the UCITS will be suitable for their needs.

The investment policy should indicate how the investment objective will be achieved. The KIID does not need to contain an exhaustive list of all investment instruments that the UCITS can hold. Unlike the prospectus, only those investment instruments likely to have a material impact on the UCITS performance are required to be included in the KIID.

### (ii) *Risk and Reward Profile*

A UCITS must calculate a Synthetic Risk and Reward Indicator (“SRRI”) in accordance with the methodology prescribed in the ESMA *Guidelines on the Methodology for the Calculation of the Synthetic Risk and Reward Indicator* (CESR/10-673).

The SRRI will correspond to a number designed to rank the fund over a scale from 1 to 7, according to its increasing level of volatility/risk-reward profile. This indicator must be disclosed in the KIID and accompanied by a narrative explanation of the limitations of the indicator and the other material risks relevant to the UCITS which are not, or not fully, captured by the methodology for the synthetic indicator (such as credit, counterparty, liquidity and operational risk).

### (iii) *Charges*

A UCITS must calculate its charges in accordance with the methodology prescribed in ESMA *Guidelines on the Methodology for the Calculation of the Ongoing Charges Figure* (CESR 10-674). The accuracy of the charges figure should be reviewed on an on-going basis and revised in accordance with the Commission Regulation.

(iv) *Past Performance*

Past performance of the UCITS is required to be presented in a bar chart covering the performance of the UCITS in accordance with the requirements of the Commission Regulation. The UCITS must also comply with the requirements in calculating past performance.

(v) *Practical Information*

The KIID for each sub-fund must also contain a practical information section as required by the Commission Regulation. The practical information section shall include the name of the trustee, where and how to obtain other practical information and all other important information as specified in the Commission Regulation.

**NOTE:** The above obligations may vary and additional disclosures may be required in the context of structured funds and master / feeder funds.

## 13.6 Pre-contractual Information

The contents of the KIID constitute pre-contractual information.

The KIID must be provided to investors free of charge in good time before their proposed subscription for shares in the UCITS. It may be provided in a durable medium or by means of a website in accordance with the requirements set out in the Commission Regulation. A paper copy must be delivered to investors free of charge on request.

As a pre-contractual document, updated KIIDs do not need to be provided to existing investors in the UCITS. However, up-to-date versions of the KIID must be made available on the website of the UCITS or its management company.

## 13.7 Updates

A material change to the SRRI requires immediate amendment. A passive change requires monitoring and may result in an amendment to the KIID if the SRRI has consistently moved category. A material change in charges requires prior amendment and a passive change requires prompt amendment.

A UCITS is required to update its KIID on an annual basis within 35 business days of each calendar year. The KIID should be reviewed and revised as appropriate and as frequently as it is necessary

to ensure that it continues to meet the requirements of the UCITS Regulations and the Commission Regulation.

### 13.8 Filing Requirements with the Central Bank

A KIID must be submitted to the Central Bank prior to the authorisation of each UCITS, or approval of a new sub-fund in the context of an umbrella UCITS. The UCITS must confirm in writing to the Central Bank that the KIID complies in full with the requirements of the UCITS Regulations, the Commission Regulation, all related ESMA Guidelines and Central Bank guidance notes. This confirmation must also state that the information in the KIID does not conflict with the content of the prospectus. This is particularly important as the UCITS or its management company can be held liable solely on the basis of any statement contained in the KIID that is misleading, inaccurate or inconsistent with the relevant parts of the prospectus for the UCITS.



## 14. Ongoing Supervision and General Regulatory Requirements

Set out below is a summary of the principal ongoing supervision and general regulatory requirements for UCITS.

### 14.1 Prospectus and Key Investor Information Document

As noted in the immediately preceding Chapters a UCITS is required to publish a prospectus and a Key Investor Information Document (“**KIID**”), which must be dated and the essential elements of which must be kept up to date.

### 14.2 Publication of Annual and Half-Yearly Reports

UCITS are required to publish an annual audited report for each financial year and an unaudited semi-annual or half-yearly report. The annual report must be published within four months of the year end, the semi-annual within two months of the period end and both must be sent to the Central Bank. Both must also be offered to investors free of charge before the conclusion of a contract and supplied to investors free of charge upon request.

Monthly statistics must also be provided to the Central Bank, normally through the Administrator.

### 14.3 Connected Party Transactions

The Central Bank has set out specific rules for connected party transactions – transactions carried out with a UCITS by its promoter, management company, trustee, investment manager or by associated or group companies. The general principle is that these have to be carried out as if effected on normal commercial terms, negotiated at arm’s length and must be in the best interests of the investors.

There are specific limitations imposed around such transactions, to include Prospectus disclosure requirements and disclosure in the financial reports of the UCITS.

### 14.4 Valuation Rules

The Central Bank has set out specific rules for the valuation of assets of UCITS in its UCITS Notices, with further clarification in its Guidance Notes 1/00.

## 14.5 Changes of Investment Objectives and Policies

Changes of investment objectives and material changes of investment policy are required to be approved in advance on the basis of written approval of all investors or on the basis of a majority of votes cast at a general meeting of investors with a reasonable notification period being provided by the UCITS to allow investors redeem their holding prior to implementation of the changes. In this context, the term “*material*” is taken to mean, although not exclusively, “*changes which would significantly alter the asset type, credit quality, borrowing limits or risk profile of the UCITS*”.

## 14.6 Board Appointments

Board appointments to UCITS VCCs, ICAVs and to Management Companies require prior approval by the Central Bank. Departures from the Board of Directors must be notified to the Central Bank immediately and there is a prohibition on common directors between the VCC/ICAV/Management Company and the Board of Directors of the Trustee. Currently two directors of a UCITS must be Irish resident. This may change depending on the outcome of a relatively recent Central Bank consultation process (p. 86). However, there is no certainty as of yet.

## 14.7 Fitness and Probity Regime

Under the Central Bank’s Fitness and Probity Regime any person performing a Pre-Approval Controlled Function (“**PCF**”) or a Controlled Function (“**CF**”) role in a UCITS is required to possess a level of fitness (i.e. competence and capability) and probity (i.e. honesty, ethical judgment and integrity, together with financial soundness) that is required to perform such a role.

Any person proposed to hold a PCF position (such as an Executive/Non-Executive Director, Chairman, a Designated Person (PCF-39) etc.) will require the prior approval of the Central Bank. This involves submitting an Individual Questionnaire (“**IQ**”) to the Central Bank for their review. Prior to submitting the IQ, the necessary fitness and probity due diligence will need to be performed as set out below.

Where it is proposed that a person is to hold a CF (such as a Company Secretary and the MLRO), this does not require the pre-approval of the Central Bank. However, any offer by the firm to hire such a person must be subject to them satisfying the necessary fitness and probity requirements.

The fitness of an individual to hold a particular PCF or CF position will be considered subjectively and will be dependent upon the function to be performed – its complexity, the risks attached to it, etc. This will include obtaining an up to date CV and evidence of professional qualifications, where relevant to the role.

In determining whether or not an individual has sufficient probity to hold a particular PCF or CF, a UCITS will need to conduct due diligence (such as judgment and bankruptcy searches) on the individual's background. In addition, the UCITS will need to obtain a 'self-certification' letter from the all PCFs and CFs which includes stating that they have read and are in compliance with the Fitness and Probity Standards ( the "Standards"), and that they will continue to comply with the Standards.

A person performing a PCF or a CF position is required to notify their employer without delay if for any reason they no longer comply with the Standards, however, as part of on-going performance monitoring, the UCITS will be required to ask all PCFs and CFs to certify at least on an annual basis that they are aware of and continue to be bound by the Standards.

A list of PCF roles and CF roles can be found on the Central Bank of Ireland website at [www.centralbank.ie](http://www.centralbank.ie).

## 14.8 Supervisory Co-operation

Under UCITS IV, existing mechanisms relating to the exchange of information and co-operation between Member State regulators have been built on and expanded to ensure the smooth implementation of the rules and consistency of approach and interpretation throughout the European Union.

For example, existing information sharing mechanisms between Member State regulators have been enhanced by allowing the regulator in one Member State to carry out on-the-spot verification of information and investigations within the territory of another Member State or have the regulator in another Member State carry out such checks. The UCITS IV Directive sets out the necessary administrative and organisational measures that Member States must take to facilitate such cooperation.



## 15. Mergers of UCITS

Ireland had for many years permitted mergers of UCITS, including cross border mergers of UCITS, subject to compliance with the Central Bank's Guidance Note 1/03, which set down the terms and conditions applicable to such mergers, including somewhat onerous voting requirements.

### 15.1 UCITS IV Cross-Border Merger Regime

UCITS IV provides for a new merger regime for UCITS funds under which Member States must allow for cross-border and domestic mergers in accordance with one or more of the following merger techniques:

- (i) an operation whereby one or more UCITS or sub-funds thereof, the "merging UCITS", on being dissolved without going into liquidation, transfer all of their assets and liabilities to another existing UCITS or a sub-fund thereof, the "receiving UCITS", in exchange for the issue to their unitholders of units of the receiving UCITS and, if applicable, a cash payment not exceeding 10% of the net asset value of those units;
- (ii) an operation whereby two or more UCITS or sub-funds thereof, the "merging UCITS", on being dissolved without going into liquidation, transfer all of their assets and liabilities to a UCITS which they form or a sub-fund thereof, the "receiving UCITS", in exchange for the issue to their unitholders of units of the receiving UCITS and, if applicable, a cash payment not exceeding 10% of the net asset value of those units;
- (iii) an operation whereby one or more UCITS or sub-funds thereof, the "merging UCITS", which continue to exist until the liabilities have been discharged, transfer their net assets to another sub-fund of the same UCITS, to a UCITS which they form or to another existing UCITS or a sub-fund thereof, the "receiving UCITS". This is the most commonly used merger technique for Irish authorised UCITS.

### 15.2 Approval Process

The merger of an Irish UCITS is subject to prior authorisation by the Central Bank. The merging UCITS is required to provide the following information to the Central Bank:

- (i) the common draft terms of the proposed merger duly approved by the merging UCITS and the receiving UCITS;

- (ii) an up-to-date version of the prospectus and the key investor information of the receiving UCITS (if established in another Member State);
- (iii) a statement by each of the trustees of the merging and the receiving UCITS verifying compliance of certain particulars with the requirements of the UCITS Regulations and the respective UCITS' fund rules; and
- (iv) the information on the proposed merger that each of the merging and the receiving UCITS intend to provide to their respective unitholders.

This information must be provided in English or in another language acceptable to the Central Bank.

The Central Bank must send a copy of the above information to the competent authorities of the receiving UCITS home Member State. Both competent authorities must then consider the potential impact of the proposed merger on investors of the merging and the receiving UCITS to assess whether appropriate information is being provided to investors.

The Central Bank will only authorise the proposed merger if the following conditions are met:

- (i) the proposed merger complies with the relevant provisions of Part 7 of the UCITS Regulations;
- (ii) the receiving UCITS has been approved to market its units in the State and in all Member States where the merging UCITS has been approved to market its units; and
- (iii) the Central Bank and the competent authority of the receiving UCITS home Member State are satisfied with the proposed information to be provided to investors, or no indication of dissatisfaction from the competent authorities of the receiving UCITS home Member State has been received.

### 15.3 Common Draft Terms of Merger

The merging and the receiving UCITS are required to draw up Common Draft Terms of Merger which must contain the following particulars:

- (i) an identification of the type of merger and of the UCITS involved;
- (ii) the background to and rationale for the proposed merger;

- (iii) the expected impact of the proposed merger on the investors of both the merging and the receiving UCITS;
- (iv) the criteria adopted for the valuation of the assets and, where applicable, the liabilities on the date for calculating the exchange ratio of units of the merging UCITS into units of the receiving UCITS (the “exchange ratio”);
- (v) the calculation method of the exchange ratio;
- (vi) the planned effective date of the merger;
- (vii) the rules applicable, respectively, to the transfer of assets and the exchange of units;
- (viii) in the case of certain mergers, the fund rules or instruments of incorporation of the newly constituted receiving UCITS.

## 15.4 Third Party Control

The custodians / trustees of the merging and of the receiving UCITS are required to verify the conformity of the particulars set out in points (a), (f) and (g) under the heading “Common Draft Terms of Merger” above with the requirements of the UCITS Regulations and the fund rules of their respective UCITS.

Further, either the custodian / trustee or an independent auditor (which can be the statutory auditors of the merging or receiving UCITS) is required to validate the following:

- (i) the criteria adopted for the valuation of the assets and, where applicable, the liabilities on the date for calculating the exchange ratio;
- (ii) where applicable, the cash payment per unit; and
- (iii) the calculation method of the exchange ratio as well as the actual exchange ratio determined at the date for calculating that ratio.

## 15.5 Information to Investors

Information on the proposed merger must be provided to the investors of the merging and receiving UCITS so as to enable them to make an informed judgement of the impact of the proposal on their investment. This information must be provided at least 30 days before the last date for requesting

repurchase or redemption or, where applicable, conversion without additional charge (as set out further under the heading “Right of Redemption” below).

The following general requirements apply:

- (i) the information to investors must be written in a concise manner and in nontechnical language that enables investors to make an informed judgement of the impact of the proposed merger on their investment; in the case of a proposed cross-border merger, the merging UCITS and the receiving UCITS, respectively, must explain in plain language any terms or procedures relating to the other UCITS which differ from those commonly used in the other Member State;
- (ii) the information to be provided to the investors of the merging UCITS must meet the needs of investors who have no prior knowledge of the features of the receiving UCITS or of the manner of its operation. It must draw their attention to the key investor information of the receiving UCITS and emphasise the desirability of reading it;
- (iii) the information to be provided to the unitholders of the receiving UCITS must focus on the operation of the merger and its potential impact on the receiving UCITS.

The information to be provided must include appropriate and accurate information on the proposed merger such as to enable investors to take an informed decision on the possible impact on their investment and to exercise their rights to vote and/or redeem their units prior to the merger becoming effective. The information is required to include the following details:

- the background to and the rationale for the proposed merger;
- the possible impact of the proposed merger on unitholders, including but not limited to any material differences in respect of investment policy and strategy, costs, expected outcome, periodic reporting, possible dilution in performance, and, where relevant, a prominent warning to investors that their tax treatment may be changed following the merger;
- any specific rights unitholders have in relation to the proposed merger, including but not limited to the right to obtain additional information, the right to obtain a copy of the report of the independent auditor or the custodian / trustee on request, and the right to request the repurchase or redemption or, where applicable, the conversion of their units without charge and the last date for exercising that right;
- the relevant procedural aspects and the planned effective date of the merger;
- a copy of the KIID of the receiving UCITS.

If either the merging UCITS or receiving UCITS has been notified for distribution in another Member State, the information document to be provided to investors in the merging/receiving UCITS must be translated into the official language of the relevant UCITS host Member State or into a language approved by its competent authorities.

## 15.6 Voting requirements

In order to be approved, mergers between UCITS must not require more than 75 % of the votes actually cast by investors present or represented at the general meeting of unitholders.

Member States may not impose (i) more stringent presence quora for cross-border than for domestic mergers or (ii) more stringent presence quora for UCITS mergers than for mergers of corporate entities.

## 15.7 Right of Redemption

Investors of both the merging and the receiving UCITS are entitled to request the redemption of their units or, where possible, to convert them into units in another UCITS with similar investment policies and managed by the same management company or by any other company with which the management company is linked by common management or control, or by a substantial direct or indirect holding. That right becomes effective from the moment that the unitholders of the merging UCITS and those of the receiving UCITS, have been informed of the proposed merger and ceases to exist five working days before the date for calculating the exchange ratio.

In the case of mergers between UCITS, the temporary suspension of the subscription, re-purchase or redemption of units may be allowed provided that such suspension is justified for the protection of the unitholders.

## 15.8 Costs

Except in cases where UCITS have not designated a management company, any legal, advisory or administrative costs associated with the preparation and the completion of the merger must not be charged to the merging or the receiving UCITS, or to any of their unitholders.

## 15.9 Law applicable to merger

For domestic mergers, the laws of the relevant Member State of the merging and receiving UCITS will determine the date on which the merger takes effect as well as the date for calculating the

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exchange ratio and, where applicable, the date for determining the relevant net asset value of cash payments. For cross border mergers, the laws of the receiving UCITS home Member State must determine those dates.

The entry into effect of the merger is required to be made public through all appropriate means in the manner prescribed by the laws of the receiving UCITS home Member State, and must be notified to the competent authorities of the home Member States of the receiving and the merging UCITS.

## 16. Cross-Border Distribution of UCITS within the EU

Under UCITS IV, the notification procedure for the cross-border distribution of UCITS has been reduced to a simple electronic regulator-to regulator communication with the distribution of the UCITS immediately permissible after such communication.

### 16.1 Form / Content of Notification

The form and content of the notification is set out in the UCITS IV Directive and comprises the following documents:

- standard model notification letter and accompanying documentation completed by the UCITS; and
- standard model attestation completed by the regulator in the UCITS home Member State (the “Home Regulator”) (together the “Notification File”).

A UCITS wishing to market in another Member State must complete and submit to its Home Regulator, via a designated email address, a standard model notification letter outlining details with respect to the UCITS including:

- (i) its legal form;
- (ii) its management company (where applicable);
- (iii) the arrangements made for marketing the UCITS in the host Member State;
- (iv) the arrangements made for the provision of payment facilities to unitholders in the host Member State; and
- (v) the arrangement made to make available the information which UCITS are required to provide to unitholders under the UCITS IV Directive. The latest versions of the UCITS’ constitutional documents; prospectus; key investor information document (“KIID”); annual report and any subsequent half yearly report must be attached to the notification letter together with a link to indicate where the latest electronic copy of these documents may be obtained in the future.

## 16.2 Home Regulator Action

Within 10 days of receipt of the notification letter from the UCITS, the Home Regulator must complete a standard model attestation setting out the date of establishment of the UCITS, its legal form, the list of sub-funds currently approved by the Home Regulator and confirmation that the UCITS fulfils the conditions set out in the UCITS IV Directive and submit the completed Notification File to the regulator in the Member State in which it is proposed to market the UCITS (the “Host Regulator”) via an email address designated by the Host Regulator.

Following the successful transmission of the Notification File, the Home Regulator shall immediately notify the UCITS and the UCITS may access the market of the Host Regulator from this date.

The regime under UCITS IV has greatly simplified the documentation required and significantly the only document which requires translation in the language of the Host Member State is the KIID. The decision to translate the other fund documents rests with the UCITS.

## 16.3 Ongoing Obligations

With regard to ongoing obligations, the UCITS must notify the Host Regulator of any amendments to the documents submitted with the notification letter (i.e. the UCITS constitutional documents; prospectus; KIID; annual report and any subsequent half yearly report). In addition the UCITS must give the Host Regulator advance notice in writing of any change to the information provided in the notification letter regarding the arrangements made for marketing or in relation to the share classes to be marketed.

It is, therefore, important to note that that the UCITS IV Directive does not facilitate a regulator-to-regulator notification in respect of amendments to the UCITS documentation and instead this responsibility rests with the UCITS.

## 17. Taxation of UCITS in Ireland

Ireland has a very favourable taxation regime for UCITS and, indeed, for funds in general. In addition, the Irish Government has shown an ongoing commitment to further promote and develop the Irish Funds Industry, evidenced annually by way of amendments introduced in the Finance Acts.

All Irish funds (UCITS or Non-UCITS) constituted as corporate entities (including the ICAV – see below for further detail) or unit trusts are subject to the same taxation regime so long as they fall within the definition of an “*Investment Undertaking*” for the purpose of Chapter 1A of Part 27 of the Taxes Consolidation Act 1997, which provides for Ireland’s favourable onshore funds regime.

### 17.1 Irish Direct Tax and Withholding Tax

Investment Undertakings (“fund” or “funds”) are not subject to Irish taxation on any income or gains they may realise from their investments. In addition, there are no Irish withholding taxes in respect of a distribution of payments by funds to unitholders or any encashment, redemption, cancellation or transfer of units in respect of unitholders who are neither Irish resident nor ordinarily resident in Ireland and who have provided the fund with the appropriate relevant declaration of non-Irish residence. The same is also true for certain categories of exempt Irish investors (e.g. approved pension schemes, charities, other investment undertakings, etc.) who have also made the appropriate declaration to the fund.

In the absence of a non-resident declaration, there is a presumption that an investor is Irish resident or ordinarily resident in Ireland. However, measures exist whereby the requirement for non-resident declarations is removed provided that appropriate *equivalent measures* are put in place by the fund to ensure that such unitholders are not Irish resident or ordinarily resident in Ireland and the fund is not actively marketed to such unitholders. The prior approval of the Irish Revenue Commissioners is required in order to operate the equivalent measures regime as an alternative to the non-resident declarations. The *equivalent measures* regime when availed of can significantly reduce the administrative burden for funds.

When, however, a distribution is made by the fund to Irish resident unitholders (or to an ordinarily Irish resident unitholder) who do not fall within any of the exempt Irish investor categories, or such a unitholder disposes of units and realises a gain, tax must be deducted by the fund at a rate of 41% (25% where the unitholder is a company and an appropriate declaration is in place) on distributions (where payments are made annually or at more frequent intervals). Similarly, tax at the rate of 41% (25% where the unitholder is a company and an appropriate declaration is in place) will have to be deducted by the fund on any other distribution or gain arising to the unitholder.

It should be noted that neither a *relevant declaration* nor the *equivalent measures* should be required in relation to units held in an ETF, as any transactions (which might otherwise be a chargeable event) in relation to units held in a recognised clearing system as designated by order of the Irish Revenue Commissioners is not a taxable event.

## 17.2 Stamp Duty

No stamp duty is payable in Ireland on the issue, transfer, repurchase or redemption of units in a fund. Furthermore, no stamp duty is payable by the fund on the conveyance or transfer of stock or marketable securities provided that the stock or marketable securities in question have not been issued by a company registered in Ireland and provided that the conveyance or transfer does not relate to any immovable property situated in Ireland or any right over or interest in such property or to any stocks or marketable securities of a company (other than a company which is a fund or a qualifying securitisation company) which is registered in Ireland.

Where any subscription for or redemption of units is satisfied by the in specie transfer of securities, property or other types of assets, consideration should be given to whether Irish stamp duty may arise on the transfer of such assets (in most cases it should not).

## 17.3 VAT

There are wide ranging VAT exemptions with regard to the provision of services to funds (e.g. administration, transfer agency, investment management, etc.) and to the extent that a fund suffers Irish VAT on certain services it receives (e.g. audit and legal fees) the fund may recover this VAT based on its recovery rate. Under current practice the recovery rate will be based on either (i) the extent that the investments of the fund are located outside the EU or (ii) the extent that the investors in the fund are located outside the EU. The Irish Revenue Commissioners prefers to rule on the fund's VAT recovery position by reference to where the investments of the fund are located, rather than where the investors in the fund are located. Nevertheless, whichever basis is used, it must be applied consistently from one period to the next.

Certain services received from abroad (e.g. the service of non-Irish lawyers or accountants) will require a fund to register and self-account for VAT in Ireland under the general reverse charge rules. Such foreign services giving rise to a VAT registration obligation on the part of a fund are commonly referred to as Business to Business services. However, depending on the fund's VAT recovery rate the fund may be able to recover some or all of this Irish VAT.

## 17.4 Compliance requirements

*Investment Undertaking Tax:* Funds have an obligation to register with the Irish Revenue Commissioners to obtain a tax reference number as each fund must file bi-annual investment undertaking tax returns. These tax returns should be accompanied by the payment of appropriate tax (if applicable) for the period in question. On the basis that there are no Irish resident or ordinarily resident unitholders (or such unitholders are exempt Irish investors) the appropriate tax should be nil.

*Payroll Taxes:* The current position of the Revenue Commissioners is that under Irish tax law remuneration arising from the office of director of an Irish incorporated company (such as an Irish incorporated corporate fund) is subject to the Pay As You Earn ("PAYE") system of deductions at source and that this is the position irrespective of either the tax residence of the director in question or where the duties of the office are performed. Generally, the only exception to the requirement to operate the PAYE system is where the director in question has obtained a PAYE Exclusion Order. Where the directors of a corporate fund are partners in an Irish law firm or accountancy firm then it may be possible for them to obtain a PAYE Exclusion Order from the Revenue Commissioners (subject to certain conditions being satisfied).

*VAT:* Once required to register for VAT, an Irish fund will have certain VAT filing and annual return obligations with the Revenue Commissioners. Any VAT refund claims are included with any VAT returns required to be made.

(It should be noted that different tax registration and reporting requirements arise in respect of a Common Contractual Fund and for further detail with respect to the registration and filing requirements for funds please see publication on our website entitled "[Funds – Overview of Irish Registration and Filing Requirements](#)").

## 17.5 FATCA

The foreign account tax compliance provisions ("**FATCA**") of the Hiring Incentives to Restore Employment Act 2010 represent an expansive information reporting regime enacted by the United States ("**US**") aimed at ensuring that Specified US Persons with financial assets outside the US are paying the correct amount of US tax. FATCA will generally impose a withholding tax of up to 30% with respect to certain US source income (including dividends and interest) and gross proceeds from the sale or other disposal of property that can produce US source interest or dividends paid to a foreign financial institution ("**FFI**") unless the FFI enters directly into a contract ("**FFI agreement**") with the US Internal Revenue Service ("**IRS**") or alternatively the FFI is located in a IGA country (please see below). A fund will be an FFI. An FFI agreement will impose obligations on the FFI

including disclosure of certain information about US investors directly to the IRS and the imposition of withholding tax in the case of non-compliant investors.

In recognition of both the fact that the stated policy objective of FATCA is to achieve reporting (as opposed to being solely the collecting of withholding tax) and the difficulties which may arise in certain jurisdictions with respect to compliance with FATCA by FFIs, the US has developed an intergovernmental approach to the implementation of FATCA. In this regard the Irish and US Governments signed an intergovernmental agreement (“**Irish IGA**”) on the 21<sup>st</sup> December 2012 and provisions were included in Finance Act 2013 for the implementation of the Irish IGA and also to permit regulations to be made by the Irish Revenue Commissioners with regard to registration and reporting requirements arising from the Irish IGA. In this regard, the Revenue Commissioners (in conjunction with the Department of Finance) have issued Regulations – S.I. No. 292 of 2014 which is effective from 1 July 2014. Supporting Guidance Notes (which will be updated on an ad-hoc basis) were issued by the Irish Revenue Commissioners on 1 October 2014.

The Irish IGA is intended to reduce the burden for Irish FFIs of complying with FATCA by simplifying the compliance process and minimising the risk of withholding tax. Under the Irish IGA, information about relevant US investors will be provided on an annual basis by each Irish FFI (unless the FFI is exempted from the FATCA requirements) directly to the Revenue Commissioners. The Revenue Commissioners will then provide such information to the IRS (by the 30<sup>th</sup> September of the following year) without the need for the FFI to enter into a FFI agreement with the IRS. Nevertheless, the FFI will generally be required to register with the IRS to obtain a Global Intermediary Identification Number commonly referred to as a GIIN. Under the Irish IGA, FFIs should generally not be required to apply 30% withholding tax.

## 17.6 EUSD

It is important to note that certain identification and reporting requirements may also arise for an Irish fund under the domestic measures implementing the EU Savings Directive. The measures are essentially designed to ensure that an individual who is resident in a Member State of the European Union and who receives savings income from another EU Member State is taxed in the EU Member State in which he/she is resident for tax purposes.

On March 18, 2015 the European Commission published a proposed Directive which will, for the most part, repeal the EU Savings Directive with effect from 1 January 2016.

## 17.7 Irish Collective Asset Management Vehicle (ICAV™)

As explained above in Chapter 11 “Available Legal Structures”, the ICAV is a new type of corporate structure which can be used for UCITS and Non-UCITS corporate funds.

One of the more significant advantages, indeed a driving force behind the introduction of the ICAV, its treatment for US tax purposes where it can “check-the-box” to be treated as a partnership or disregarded entity for US federal tax purposes. Therefore, an ICAV should be able to facilitate investment by US taxable investors and/or US taxable and tax-exempt investors in a master / feeder fund structure. This is different to the treatment of Irish corporate funds incorporated as public limited companies under the Irish Companies Acts (PLCs) which cannot check-the-box to be a flow-through for US tax purposes.

In terms of its domestic tax treatment, the ICAV will be subject to the same attractive Irish tax regime that currently applies to the other corporate funds (i.e. no Irish tax at the fund level, no Irish withholding taxes on distributions where shareholders are not Irish resident or ordinarily resident in Ireland and an attractive indirect tax regime whereby many services provided to a fund are VAT exempt and the issue, redemption or transfer of shares are not subject to any transfer taxes).

Furthermore, the ICAV (like other corporate funds) should have the same access to many of Ireland’s double taxation agreements. Ireland has signed comprehensive double taxation agreements with 72 countries, of which 68 are in effect, so as to minimise the possible effect of foreign withholding taxes on returns on its investments.



## 18. UCITS Management Companies / Self-Managed UCITS

Due to their legal nature, UCITS established as unit trusts or as CCFs require a UCITS Management Company in their structure. This is because a unit trust is created by a Management Company and Trustee entering into a constitutive document known as a *trust deed* and, in the case of a CCF, it is constituted contractually by the Management Company unilaterally entering into a *deed of constitution*.

UCITS established as ICAVs or as VCCs have the option as to whether or not to appoint a management company. Those which do not appoint a management company are known as “*self-managed*” UCITS.

Up until UCITS IV, the Management Company of a UCITS had to be located in the same jurisdiction as the UCITS itself. Since UCITS IV, the Management Company of a UCITS can be located in a different EU Member State to that of the UCITS. That means that an Irish UCITS Management Company can manage an Irish UCITS and, for example, an Italian UCITS or a Luxembourg UCITS. In fact, given the new opportunities under AIFMD (and also the individual portfolio management passporting capacity of UCITS and, in time, under AIFMD), a UCITS Management Company in Ireland can act as a management company to an Irish UCITS, as an AIFM to a UK AIF and also provide investment management services to, for example, an Italian domiciled insurance company.

### 18.1 Management Company

In the fund management industry, particularly when dealing with collective investment schemes, the terms “Management Company” and “Investment Manager” have had different meanings, different functions and different passports. These distinctions can at times become blurred but it is important to understand which entities we are referring to when we use those terms, as explained further below.

When we refer to a “Management Company” (the term “Management Company” and “Manager” are used interchangeably and refer to the same entity), we are referring to the entity which has the ultimate responsibility for the overall management of a collective investment scheme. This overall management function encompasses overall control of the collective investment scheme, including the discretionary investment management function, the fund administration function and the distribution function and is referred to generally as “*collective portfolio management*”.

If a Management Company is used for an Irish collective investment scheme, the contractual arrangements are structured so that the Management Company is mandated to carry out investment management, fund administration and distribution in respect of the Irish domiciled collective

investment scheme but, in most cases, the Management Company delegates out fund administration to a regulated administrator and delegates, the distribution activity to a distributor in the jurisdiction where the UCITS is being distributed. It may also delegate activity to an appropriately regulated Investment Manager which, if it is a European entity, would most likely be authorised in its home EU Member State under the Markets in Financial Instruments Directive (“**MiFID**”).

We are, however, seeing some UCITS Management Companies retaining more risk and/or portfolio management activities themselves, particularly where they are obtaining dual UCITS ManCo / AIFM authorisations.

## 18.2 Permitted Activities of UCITS Management Companies

A UCITS Management Company can be authorised for *collective portfolio management* and, but not or, for individual portfolio management. This means that a UCITS Management Company can act as Management Company to collective investment schemes and, if it wishes to expand its authorisation, it can also provide discretionary asset management services to other types of clients (i.e. clients which are not collective investment schemes) such as pension funds, corporates, insurance companies and retail investors referred to generally as “*individual portfolio management*”.

See Appendix C for the full range of services and an explanation of the terms *collective portfolio management* and *individual portfolio management* as they apply to UCITS Management Companies.

A UCITS Management Company can also be an alternative investment fund manager (“**AIFM**”) which would allow it manage alternative investment funds (“**AIFs**”). That opens up additional opportunities for a single legal entity with a single board and with a single capital adequacy requirement to manage UCITS, AIFs and other types of clients and across multiple jurisdictions. This is a very significant opportunity and, given that MiFID firms cannot be AIFMs, we have seen a number of MiFID asset managers give up their MiFID authorisations in place of a dual UCITS / AIFM authorisation.

## 18.3 Management Company Passport

The Management Company passport allows a UCITS Management Company to pursue in other EU Member States the activities for which it has been authorised in its home Member State, including the management of UCITS domiciled in other Member States. This can be achieved either (i) through the establishment of a branch or (ii) on a freedom of services basis.

The Management Company passport was first introduced under UCITS III and perfected under UCITS IV.

## 18.4 Establishment of Branch

A Management Company wishing to establish a branch in another EU Member State must notify its home regulator of its intention to do so. Such notification will be required to include:

- (i) the name of the other EU Member State in which it intends to operate;
- (ii) a programme of operations including a description of the activities envisaged and the organizational structure of the branch;
- (iii) a description of the risk management process put in place by the Management Company; and
- (iv) the address of the Management Company in its host Member State from which documents may be obtained and details of those responsible for the management of the branch.

## 18.5 Freedom to Provide Services

A Management Company wishing to pursue activities in another EU Member State under the freedom to provide services must notify its home regulator and provide it with the following information:

- (i) the name of the other EU Member State in which it intends to operate; and
- (ii) a programme of operations including stating the activities and services it will undertake, including a description of the risk management process put in place by the management company.

The Management Company's home regulator must communicate the completed information to the regulator in the host Member State within two months of receiving the completed notification, in the case of a branch, and one month, in the case of the free provision of services. Where the Management Company wishes to pursue the activity of collective portfolio management, its home regulator shall also send to the regulator in the host Member State an attestation of the scope of the Management Company's authorisation along with details of any restriction on the types of UCITS that the Management Company is authorised to manage.

A Management Company which is establishing a branch in another Member State will be subject to the rules of conduct applicable to Management Companies in that Member State. It shall be entitled

to commence business on receipt of confirmation from the regulator in the host Member State or two months from the date when its home regulator notified the regulator in the host Member State.

A Management Company which is providing its services under the freedom to provide services, shall be entitled to commence providing its services into the other EU Member State within one month from the date when its home regulator provided the notification information to the regulator in the host Member State.

A Management Company which pursues the activity of collective portfolio management on a cross-border basis by establishing a branch or under the freedom to provide services must comply with the rules of its home Member State which relate to organizational requirements, delegation arrangements, risk management procedures, prudential rules and supervision. It is its home regulator who is responsible for the supervision of compliance with these requirements.

In addition, a Management Company which provides collective portfolio management in another EU Member State must comply with the rules of the UCITS home Member State which relate to the constitution and functioning of the UCITS. These include the investment policies and limits, valuation of assets, marketing arrangements and obligations contained in the prospectus and fund rules (i.e. articles of association, trust deed or deed of constitution).

Where a UCITS is managed by a Management Company in a different Member State, the Management Company and the custodian will be required to enter into a written agreement regulating the flow of information deemed necessary to allow the custodian to perform its functions.

Importantly, under UCITS IV, the home Member State of the UCITS may not impose additional requirements such as capital requirements or requirements in relation to the performance or delegation of services. It will nevertheless be important to consider tax implications when determining whether to avail of the passport.

## 18.6 Additional Central Bank Passporting Requirements

The Central Bank has set out a series of additional requirements that Irish UCITS Management Companies must address when seeking to passport into other EU Member States. These are set out in its Guidance Note on the Organisation of Management Companies and include:

- (i) a requirement for a UCITS ManCo to revisit its required resources, looking at the nature, scale and complexity of its business; and
- (ii) a requirement to consider the impact of managing non-Irish UCITS on its corporate governance, its administration function and its interaction with the non-Irish trustee / depository.

## 18.7 Anti-Letterbox Requirements and Managerial Functions

A UCITS Management Company cannot be an empty box, must be managed by at least two persons and the board must be responsible as a whole for the following ten key management functions.

- (i) *Decision taking*: there must be clear responsibility and competence in relation to all material decisions affecting the operation and conduct of business of the Management Company. Generally, the Central Bank considers that key strategic and material issues / decisions relating to the Management Company should be considered by its board of directors;
- (ii) *Monitoring compliance*: the board must put in place procedures designed to ensure compliance with all applicable legal and regulatory requirements;
- (iii) *Risk Management*: the board must put in place procedures designed to ensure that all applicable risks pertaining to the UCITS can be identified, monitored and managed at all times;
- (iv) *Monitoring of Investment Policy, investment strategies and performance*: the board must put in place procedures to ensure and verify that the investment policies and strategies are complied with and to ensure the availability of up-to-date information on portfolio performance;
- (v) *Financial Control*: the board must put in place procedures to ensure all relevant accounting records are properly maintained and are readily available including production of annual and half-yearly financial statements;
- (vi) *Monitoring of Capital*: the board must put in place procedures to ensure compliance with applicable capital adequacy requirements;
- (vii) *Internal Audit*: the board must put in place procedures to ensure effective internal audit procedures;
- (viii) *Supervision of Delegates*: the board must have clear structures in place for the ongoing monitoring of work delegated to third parties;
- (ix) *Complaints Handling*: the board must have arrangements in place to ensure that complaints from unitholders are addressed promptly and effectively;

- (x) *Accounting Policies and Procedures*: the board must have procedures in place to ensure that proper accounting policies and procedures are employed in respect of the management company and all collective investment schemes under management.

**Note:** Both Management Companies and self-managed UCITS are required to demonstrate compliance with the above management requirements.

**Note:** The Central Bank has announced (at IFIA Conference on June 11, 2015) that “these managerial functions have been streamlined to six key areas covering (i) investment portfolio management, (ii) investment risk management, (iii) distribution, (iv) operational risk, (v) capital and financial management and (vi) compliance. The Central Bank will also clarify the meaning of the “designated person” role – a fund governance concept which has been in existence since 2003 but which has evolved as a result of regulatory change and industry practice; in particular, we make it clear that designated persons are responsible for managerial functions in the fund management company.”

In advance of commencing operations, a Management Company must submit a detailed Application for Authorisation and a Business Plan to the Central Bank setting out how the above functions are going to be performed, by whom, where and what reporting lines are put in place.

## 18.8 Organisational Requirements

UCITS IV introduced new MiFID like organisational and internal control requirements, conflicts of interest requirements and risk management requirements for UCITS Management Companies. In addition, UCITS Management Companies are required to comply with certain rules of conduct. The requirements affect all UCITS Management Companies, whether they operate on a fully delegated basis (delegating out administration, investment management and distribution activities) or whether they retain, for example, administration and delegate out investment management and distribution. Self-managed UCITS are equally affected by the organisational requirements.

Importantly, the UCITS IV Directive recognises the principle of proportionality. In other words, the application of most (but not all) of the new organisational requirements must take into account the nature, scale, and complexities of different UCITS Management Companies. Factors which may be relevant in determining the extent to which the proportionality principle should apply may include the number of UCITS managed, number of sub-funds within umbrellas, the extent of use of derivatives or of complex trading strategies, number of investors etc.

A summary of the current organisational requirements is set out below. It should be noted that the following section focuses on UCITS Management Companies carrying out collective portfolio management, not individual portfolio management.

- (i) *General Requirements:* Management Companies are required to have adequate internal organisational and control mechanisms, clear reporting lines and assignment of responsibilities. Other requirements imposed are to protect confidentiality, the security and integrity of information and the requirement to ensure adequate business continuity policies. The principle of proportionality and the recognition of the ability to delegate, as highlighted above, apply.
- (ii) *Resources:* Management Companies are required to employ “personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them” and to carry out due diligence on delegates. This requirement is subject to the proportionality principle referred to above. As highlighted above, the UCITS IV Directive recognises that UCITS Management Companies should be able to delegate some of their activities to third parties, provided proper due diligence checks are carried out and delegates are monitored.
- (iii) *Complaints:* Management Companies are required to establish, implement and maintain effective and transparent procedures for complaints handling. Each complaint and the measures taken for its resolution must be recorded, investors must be able to file complaints free of charge and management companies must make information regarding complaint handling available to investors free of charge.
- (iv) *Electronic data processing, record keeping and other recording requirements:* Management Companies are required to ensure timely and proper recording of each portfolio transaction and of subscription and redemption orders. In addition, they are required to ensure appropriate safeguards are put in place to ensure that electronic data processes are secure and that the integrity and confidentiality of recorded information in respect of the UCITS is maintained. UCITS IV also imposes detailed record keeping obligations in a similar manner to the requirements under MiFID.
- (v) *Accounting procedures:* From an accounting perspective at least, all assets and liabilities of a UCITS must be directly identifiable at all times. This would appear to be a practical necessity anyway in terms of the NAV calculation process.
- (vi) *Control by senior management and supervisory function:* UCITS IV requires reinforced oversight duty by senior management in respect of delegated service providers. Senior management (which can include directors) must receive on a frequent basis, and at least annually, written reports on matters of compliance, internal audit and risk management, investment policy and strategies indicating in particular whether appropriate remedial

measures have been taken in the event of any deficiencies. On a regular basis they must also receive various other written reports relating to the discharge of those functions.

- (vii) *Compliance function, internal audit function and risk management function:* UCITS IV requires a permanent compliance function, internal audit function and a permanent risk management function respectively for Management Companies. These requirements are subject to the proportionality principle referred to above.
- (viii) *Risk Management Policy:* Management Companies are, again subject to the proportionality principle, required to establish, implement and maintain an adequate risk management policy, which addresses all risks which may be material for the Management Company, including market, liquidity, counterparty and operational risks.
- (ix) *Exercise of Voting Rights:* Management Companies are required to develop adequate and effective strategies for determining when and how voting rights attached to instruments held in the UCITS' portfolios are to be exercised, to the exclusive benefit of the UCITS concerned. The strategy for the exercise of voting rights shall determine measures and procedures for monitoring relevant corporate events, ensuring that the exercise of voting rights is in accordance with the investment objectives and policies of the relevant UCITS and preventing or managing any conflicts of interest arising from the exercise of voting rights.
- (x) *Personal Transactions:* Management Companies are required to identify and record "relevant person's" personal transactions and to ensure the notification and recording of personal transactions to the Management Company. They are also required to ensure that proper preventative measures are put in place to prevent potential breaches by individuals of the market abuse rules.

A "relevant person" means any of the following:

- (a) a director, partner or equivalent, or manager of the management company or investment company;
- (b) an employee of the management company or investment company, as well as any other natural person whose services are placed at the disposal and under the control of the management company or investment company and who is involved in the provision by the management company or investment company of collective portfolio management;
- (c) a natural person who is directly involved in the provision of services to the management company under a delegation arrangement to third parties for the

purpose of the provision by the management company of collective portfolio management.

- (xi) *Conflicts of Interest:* The UCITS IV Directive extends to UCITS and their Management Companies, the provisions under MiFID which requires investment firms to identify, manage and disclose their conflicts of interest. In this regard, Management Companies are required to adopt a written policy which will (a) identify when potential conflicts will arise and in doing so, they will need to consider the implications of group entities; and (b) set out the procedures to be followed and measures to be adopted in order to manage such conflicts. Again, the proportionality principle applies.
- (xii) *Rules of Conduct:* The rules of conduct are broadly grouped into four main areas, namely, the duty to act in the best interests of UCITS and their unitholders, the duty of Management Companies to ensure a high level of diligence on the selection and monitoring of investments in the best interests of the UCITS they manage, reporting obligations in respect of execution of subscription and redemption orders, and best execution and order handling rules. With regard to the latter, MiFID type best execution rules are now applied and UCITS Management Companies are required to take all reasonable steps to obtain the best possible result for the UCITS, taking into account price, costs, speed, likelihood of execution and settlement, order size and nature, or any other consideration relevant to the execution of the order.
- (xiii) *Inducements:* The UCITS IV Directive prohibits a Management Company from receiving fee and commission payments as well as non monetary benefits in relation to the activities of investment management and administration, except if:
  - (a) paid or provided to or by the UCITS or on behalf of the UCITS;
  - (b) paid or provided to or by a third party (other than the UCITS) provided there is appropriate disclosure and the payment is designed to enhance the quality of the service; or
  - (c) proper fees which enable or are necessary for the provision of the relevant service, including custody costs, settlement and exchange fees, regulatory levies or legal fees, and which by their nature, cannot give rise to conflicts with the management company duty to act in the best interests of the UCITS.

UCITS IV recognises that UCITS Management Companies should be able to delegate some of their activities to third parties provided, inter alia, proper due diligence checks are carried out to ensure the third party is qualified. In many cases, therefore, UCITS management companies meet their

obligations set out above by ensuring that their delegates meet the requirements of the Directive (and by obtaining comfort from their delegates in the form of agreements, side letters or otherwise). Ultimate responsibility for ensuring that they do so, however, rests with the Management Company.

## 18.9 Capital Adequacy

A UCITS Management Company must have at all times:

- (i) initial capital of at least €125,000 (“**Initial Capital Requirement**”) plus the Additional Amount (if required), as set out below; or
- (ii) one quarter of its total expenditure taken from the most recent annual accounts (“**Expenditure Requirement**”).

whichever is higher (“**Minimum Capital Requirement**”).

When the net asset value of the collective investment scheme under management exceeds €250,000,000, a Management Company must provide an additional amount of capital equal to 0.02% of the amount by which the net asset value exceeds €250,000,000 (“**Additional Amount**”). A Management Company need not provide up to 50% of the Additional Amount if it benefits from a guarantee of the same amount given by a credit institution or insurance undertaking and the form of guarantee is approved by the Central Bank.

The total of the Initial Capital Requirement and the Additional Amount required to be held by a Management Company is subject to a maximum of Euro 10,000,000. A Management Company is required to hold the higher of the Expenditure Requirement or the Initial Capital Requirement in the form of eligible assets, which must be easily accessible, free from liens and maintained outside the Management Company’s group.

The minimum capital requirement for a self-managed UCITS is Euro 300,000. It is not subject to any additional expenditure or other requirements.

## 18.10 ManCo Authorisation Procedure

The current application process for a UCITS Management Company engaged in collective portfolio management only and which delegates out the fund administration, asset management and distribution functions to third parties is as set out below. An initial meeting with the Central Bank should be organised to introduce the parent group. This will be followed by preparation, completion and filing with the Central Bank of the following documents:

- (i) formal Application for Authorisation (there is a specific application form for this purpose);
- (ii) detailed Business Plan setting out the legal nature of the Management Company, types of activities which it proposes carrying on, its organisational structure, how it will perform the ten oversight functions, three year financial projections, details of proposed capitalisation, overall group structure, sample of transaction flows for the type of transactions to which it will be engaged;
- (iii) Individual Questionnaires for each of its proposed Directors, senior management, each individual who holds directly or indirectly 10% or more of the capital or voting rights of the company and of any other individual who is in a position to exercise significant influence over the management of the company;
- (iv) Code of Conduct, Anti-Money Laundering procedures, reporting lines etc;
- (v) Group structure details (considerable information may be required).

Following review of these documents the Central Bank will then enter into correspondence with the applicant which regularly takes the form of submitting additional documentation and providing clarifications where required.

For reasonably complete applications, the normal authorisation time is approximately four months. It is important to note that the authorisation of the Management Company will normally run in tandem with the authorisation of the first UCITS to be managed by the Management Company.



## 19. Corporate Governance

Following the Central Bank's request to the Irish Fund(s) Industry Association ("IFIA") in April 2010 to develop a voluntary Corporate Governance Code for the funds industry in Ireland, the IFIA published its "Corporate Governance Code for Collective Investment Schemes and Management Companies" (the "Code"), which became effective from 1st January, 2012, subject to a 12 month transitional period.

### 19.1 General Applicability

The Code relates to all Irish domiciled funds (including UCITS) and management companies, except management companies appointed by corporate funds. The Code is a voluntary code and where a board adopts the Code but decides not to apply any provision of the code, it must set out its reasons why in the Directors' Report accompanying the annual audited accounts, or alternatively publish the information through a publicly available medium (e.g. website) detailed in the annual report.

If the Code is not adopted, there are no immediate implications other than the Central Bank may determine to compulsorily apply the Code to funds and management companies generally and then apply the Central Bank's Administrative Sanctions regime to the Code.

Funds whose shares are listed on a regulated market will still have an obligation to disclose details regarding corporate governance in the Directors' Report accompanying the annual audited accounts.

### 19.2 Composition of the Board

The Code recommends that the minimum number of directors should be three directors and that a board comprise a majority of non-executive directors.

A non-executive director is defined, for the purposes of the Code, as a person who is not directly involved in the day to day discretionary investment management of the fund. It recommends that a board have at least one independent director who would not be an employee, partner, significant shareholder or director of a service provider firm, or provider personally of services receiving professional fees (other than directorships fees) from the fund or management company. It also sets down certain criteria to be considered when determining if a director is independent (i.e. whether a person has the ability to exercise sound judgement and decision making independent of the views of the promoter, the service provider(s), political interests or inappropriate outside interests).

The Code recommends that at least one director be an employee, partner or director of the promoter or investment manager and that there be a non-executive Chairman appointed to the Board.

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### 19.3 Time Commitments

A board must document the time commitment expected from each director in a letter of appointment and directors are required to disclose in writing to a board their other time commitments, including time devoted to the role of directors of collective investment schemes domiciled in foreign jurisdictions.

The board must satisfy itself that the directors have sufficient time to fully discharge their duties and there is a rebuttable presumption that a maximum of eight directorships held outside Irish and non-Irish funds and management companies (“Non-Fund Directorships”) may be held without impacting a director’s time available to fulfil his or her role and functions as a director of a fund or management company. Non-Fund Directorships are deemed not to include other directorships of entities with which the director is deemed to be affiliated i.e. group directorships and certain other directorships set out in the Code.

### 19.4 Role of the Board

Key/strategic decisions relating to a fund or management company should be considered by the board, including, but not limited to:

- (iv) creation/termination of new sub-funds and classes of shares;
- (v) changes in investment objectives, policies and restrictions;
- (vi) temporary suspension in the calculation of net asset value;
- (vii) approval of dividends, fees and expenses of the applicant firm;
- (viii) appointment and removal of service providers;
- (ix) anti-money laundering and counter-financing of terrorism risks of the fund or management company;
- (x) approval of financial statements of the fund or management company; and
- (xi) any other decisions of a strategic nature.

### 19.5 Meetings

The Code suggests that a board should normally meet quarterly and that all directors are expected to attend and participate. An attendance schedule should form a part of the annual informal board performance review process.

## 19.6 Reviews

The recommendation is that a board should review the overall board's performance and that of individual directors annually, with a formal documented review taking place at least once every three years.

Funds and management companies should formally review board membership at least once every three years and the Chairman of a board should be reviewed at least once every 3 years.

A board should document its procedures for dealing with conflicts of interest and should review compliance with those procedures at least annually.

The IFIA has since published a Corporate Governance Code for fund service providers, which was issued in July, 2014, and contains many provisions similar to those set out in the Code.

## 19.7 CP 86

The Central Bank published a Consultation Paper 86 ("**CP86**") on a number of initiatives which it said were '*designed to underpin the achievement of substantive control by fund management companies, acting on behalf of investment funds, over the activities of their delegates*'.

Four key areas discussed by the Central Bank in CP 86 relate to:

- guidance on how fund management companies should oversee delegates;
- reduction of the number of existing management functions and streamlining these functions;
- removal of current requirement to have two Irish resident directors (and suggesting replacement provisions); and
- introduction of a requirement to provide a rationale for board composition

We have yet to receive clarity as to the outcome of CP86 other than to learn, through a recent speech from a senior Central Banker, that it has, somewhat surprisingly, decided not to drop the two

Irish resident director rule nor to impose a numerical limit on the number of directorships which an individual can hold.

**Note:** The Central Bank has announced (at IFIA Conference on June 11, 2015) that “these managerial functions have been streamlined to six key areas covering (i) investment portfolio management, (ii) investment risk management, (iii) distribution, (iv) operational risk, (v) capital and financial management and (vi) compliance. The Central Bank will also clarify the meaning of the “designated person” role – a fund governance concept which has been in existence since 2003 but which has evolved as a result of regulatory change and industry practice; in particular, we make it clear that designated persons are responsible for managerial functions in the fund management company.”

## 20. UCITS Authorisation Process

The authorisation process for UCITS has two parts, one dealing with the promoter of and service providers to the UCITS and the second dealing with the UCITS product itself.

### 20.1 Approval of Service Providers

In addition to the Management Company (as outlined above), the principal service providers to a UCITS are the Investment Manager, Administrator and the Trustee/Custodian. The entity promoting the UCITS must also be approved.

### 20.2 Promoter

Before an application for authorisation of a UCITS can be considered, the Central Bank must be satisfied that the Promoter of the UCITS is acceptable to it. The Central Bank regards the Promoter as being the driving force behind the product (i.e. the entity without whom the UCITS would not be brought to the market). Promoters must be of good repute and should have a significant level of financial resources (at least Euro 635,000) and a demonstrable and relevant track record in the promotion of funds. In considering the suitability of the Promoter of a UCITS, the Central Bank requires detailed information to enable it gain an appreciation of the Promoter and the nature of its business. Information to be provided includes:

- (i) details of the main activities of the Promoter since its establishment
- (ii) its experience and expertise in the promotion and management of collective investment schemes
- (iii) ownership details
- (iv) details of distribution networks
- (v) latest audited accounts in respect of the Promoter and its ultimate owners
- (vi) confirmation that the Promoter is regulated in its home jurisdiction and
- (vii) auditor's confirmation that the Promoter has adequate financial resources.

## 20.3 Investment Manager

Where the asset management of a UCITS is, as is usual, delegated to a third party Investment Manager, the UCITS Directive imposes two principal requirements. Firstly, only an Investment Manager which is authorised or registered for the purpose of asset management and who is subject to prudential supervision may be appointed. Secondly, where a non-EU Investment Manager is appointed, there must be a form of co-operation in place between the Central Bank and the supervisory authorities of the third country Investment Manager.

If the Investment Manager is an entity authorised to carry out discretionary asset management under MiFID or the UCITS Directive, the Central Bank will not apply a detailed review and approval process but rather will require confirmation from the Home Member State regulator that the Investment Manager has the appropriate regulatory status.

If the Investment Manager is not authorised to carry out discretionary asset management under MiFID (such as US, Japanese etc Investment Managers), the Central Bank will normally apply a detailed review and approval process. In both cases, a detailed application for approval needs to be submitted. Where a Promoter also acts as Investment Manager, a separate application for approval to act as Investment Manager is not required.

## 20.4 Administrator

Although, under UCITS IV, there is scope for such services to be passported into Ireland (please refer to the Chapter relating to UCITS management companies, which sets out further information with regard to the management company passport), typically, an Irish administrator is appointed to provide administration services to a UCITS.

If the administration function is carried out by an Irish administrator, it must be authorised by the Central Bank to provide administration services under the Investment Intermediaries Act, 1995 (as amended) and/or MiFID. Although an Irish authorised administration company may be permitted to outsource certain administration activities, the “core administration activities” of the final checking and release of the UCITS net asset value calculation for dealing purposes and the maintenance of the shareholder register cannot be outsourced.

## 20.5 Custodian / Trustee

The custodian of a UCITS must be a credit institution authorised in Ireland, an Irish branch of an EU credit institution or an Irish incorporated company which is wholly owned by an EU credit institution

(or equivalent from a non-EU jurisdiction) provided that the liabilities of the Irish company are guaranteed by its parent.

A custodian / trustee of an Irish UCITS has a dual role (i) to “oversee” the manner in which the UCITS is managed and (ii) to safe-keep the assets of the UCITS, in each case in accordance with the requirements set down by the Central Bank.

It should be noted that new requirements in relation to the role of the custodian/trustee of a UCITS, including requirements in relation to eligibility, delegation and liability have been set out in UCITS V. Please refer to Chapter 21 for further detail of UCITS V.

## 20.6 UCITS Documentation Requirements

The following documents are currently required to be submitted to the Central Bank in support of an application for authorisation of a UCITS:-

- (i) Central Bank Application Form for Authorisation of a UCITS
- (ii) Business Plan
- (iii) Prospectus
- (iv) \*Memorandum and Articles of Association/Instrument of Incorporation/Trust Deed/CCF Deed
- (v) \*Custodian Agreement
- (vi) Administration Agreement
- (vii) Investment Management/Advisory Agreement
- (viii) Distribution Agreement (optional)
- (ix) Placing Agreement (optional)
- (x) Derivatives Risk Management Process
- (xi) Individual Questionnaires for directors of VCC/ICAV or Management Company
- (xii) Ancillary Letters

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(xiii) \*\*Key Investor Information Document

\*The documentation required will vary depending on the structure of the UCITS (i.e. if it is established as a variable capital investment company, an ICAV, a unit trust or CCF).

\*\*Please refer to the following Chapter in this document, which sets out further information with regard to the Key Investor Information Document.

Note that certain documentation for variable capital investment companies and, if new, Management Companies will also need to be submitted to the Companies Registration Office.

## 20.7 Timing

On average it takes approximately 6-8 weeks from date of initial submission of an application to the Central Bank for authorisation of the UCITS to issue.

## 20.8 Regulatory Fees

The Central Bank imposes an annual industry funding levy on collective investment schemes. Rates (at time of writing) include a minimum annual fee of Euro 1,700 whether an umbrella or a single structure fund. Umbrella funds with more than one sub-fund also pay a contribution per sub-fund of Euro 260 on the first ten sub-funds and a further levy of Euro 160 on sub-funds greater than ten, to a maximum of twenty sub-funds, resulting in a maximum contribution for umbrella funds of Euro 5,900.

## 21. UCITS V AND UCITS VI

As part of continuing efforts to improve the UCITS framework and maintain investor confidence in the UCITS product, the European Commission has issued new legislative proposals of UCITS, commonly referred to as “**UCITS V**” and “**UCITS VI**”, as further detailed below. The principal aim of the reform is to create uniform market conditions across the EU, thereby increasing investor protection and investor confidence and safeguarding the integrity of the UCITS market and brand worldwide.

### 21.1 UCITS V

In July 2012, the European Commission released a proposal on the revision of the UCITS regime in respect of depositary functions, remuneration policies and sanctions. Directive 2014/91/EU (“UCITS V”) came into effect on September 17, 2014, and EU member states are required to transpose UCITS V into their national laws by March 18, 2016.

UCITS V is a further revision to the UCITS regime which aims to bring the UCITS regime into line in certain respects with the Alternative Investment Fund Management Directive (“AIFMD”) and introduce a range of corresponding measures which had hitherto been regulated in somewhat less prescriptive terms. The amendments to the existing UCITS regime aim to address lessons learned from the financial crises, most notably from the Madoff case which highlighted the lack of consistency in the application of the provisions of the UCITS Directive by Member States of the EU.

UCITS V focuses on three main areas namely; (i) UCITS depositary’s eligibility, functions and liability in circumstances where assets are lost in custody; (ii) rules governing remuneration policies which UCITS will be obliged to introduce; and (iii) the harmonisation of the minimum administrative sanctions regime across EU Member States.

### 21.2 Depositary Requirements

Under the original UCITS V proposal, the depositary had to be either a credit institution or a MIFID investment firm. In the final text of UCITS V, a third category of eligible depositary was included, namely, any other legal entity authorised by the competent authority under the laws of the Member State to carry on depositary activities which is subject to capital adequacy and own funds requirements and which is subject to prudential regulation, ongoing supervision and satisfies certain minimum requirements, including requirements in relation to infrastructure, experience, administrative and accounting procedures, internal control mechanisms, procedures for risk assessment and arrangements to prevent conflicts.

This third category of eligible depositary is a welcome development given that in Ireland only a small minority of entities authorised by the Central Bank to provide depositary services would have fallen within the narrow categories of credit institutions or of MiFID firms as proposed in the Commission's original proposals.

Existing depositaries of UCITS who do not fall into the above three categories will have a 2 year grandfathering period within which to convert into eligible entities.

### 21.3 Delegation

The rules in relation to the delegation of custody are now aligned with those set out in the Alternative Investment Fund Managers Directive (“**AIFMD**”). Under UCITS V, a UCITS depositary will only be permitted to delegate all or part of its safekeeping tasks to a sub-custodian where certain conditions are satisfied, including:

- (i) the tasks are not delegated with the intention of avoiding the requirements of the UCITS Directive;
- (ii) there must be an objective reason for the delegation; and
- (iii) the depositary must exercise all due skill, care and diligence in the selection and appointment of any sub-custodian and there must be periodic review and ongoing monitoring of the sub-custodian.

The depositary must also determine that the sub-custodian itself satisfies certain requirements during the performance of the tasks delegated to it, including the requirement to have structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the UCITS. The sub-custodian must also segregate the assets of the depositary's clients from its own assets and from the assets of the depositary so that they can be clearly identified as belonging to the clients of the depositary.

In circumstances where the appointment of a sub-custodian is required under local law, the depositary may appoint a local entity which does not satisfy the delegation requirements set out in UCITS V provided that investors are informed that the delegation is required due to local legal constraints in such third country and are informed, of the circumstances of the delegation and are informed “*of the risks involved in such delegation*” (the latter text having been agreed in the final compromise text).

Assets held in custody will not be permitted to be reused by the depositary or any third party unless certain conditions are met, including a new requirement set out in the final compromise text that the transaction “*is covered by high quality and liquid collateral received by the UCITS under a title transfer arrangement*” where the market value of the collateral is at all times at least equal to the market value of the reused assets plus a premium.

It is also of note that, notwithstanding the wording put forward by the European Council and the Parliament in earlier drafts of the UCITS V Directive, the final compromise text of UCITS V provides that UCITS will be required to disclose in its prospectus a description of any safekeeping functions delegated by the depositary, the list of delegates and sub-delegates and any conflicts of interest that may arise from such delegation. This new provision can be distinguished from the requirement in the AIFM Directive which merely stipulates that such information should be made available to investors (not that it must be disclosed in the prospectus).

## 21.4 Depositary Liability

With the aim of harmonising depositary liability under UCITS V, new requirements in relation to depositary liability have been introduced. Similar to AIFMD, UCITS V distinguishes between:

- (i) financial instruments that are capable of being held in custody, where the depositary will be liable for the loss of such assets on a strict liability basis (i.e. irrespective of fault or negligence) unless the depositary can prove that the loss of assets is due to an “external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary”; and
- (ii) all other assets (such as OTC derivatives), which are subject to recordkeeping and ownership verification duties and where the depositary will only be liable if a loss is suffered as a result of its negligence or intentional failure to properly fulfil its obligations under the Directive.

In the case of (i) above, a UCITS depositary is obliged to return a financial instrument of the identical type or corresponding amount to the UCITS, without undue delay, if it is deemed liable for the loss.

In addition, the depositary’s liability will not be affected by the fact that it has entrusted to a third party all or some of its custody tasks. Therefore, the depositary will be liable for the loss of assets even where the loss occurred at the level of the sub-custodian. Unlike depositaries of alternative investment funds, which are permitted under AIFMD to transfer

liability for the loss of financial instruments held in custody to the relevant sub-custodian, depositaries of UCITS will not be permitted to exclude or limit their liability under contract. In its original proposal, the Commission noted that it would be inappropriate and unfeasible to require retail investors to understand the consequences of such contracts.

UCITS V also gives new rights to all UCITS investors so that they are able to directly or indirectly have recourse to the UCITS depositary.

## 21.5 Duties of the Depositary

In addition to the new safekeeping requirements referred to above, UCITS V includes a uniform list of oversight duties (similar to the existing oversight duties applicable to depositaries of Irish UCITS) as well as new cash flow monitoring requirements. Similar to AIFMD, UCITS depositaries will now be required to ensure that the cash flows of UCITS are properly monitored and to ensure that all payments made by or on behalf of an investor upon the subscription of units have been received and that all cash has been booked in cash accounts that meet certain conditions.

Furthermore, in performing its tasks, a depositary will be obliged to act honestly, fairly, professionally, independently and in the interest of the UCITS and its investors.

## 21.6 Remuneration

Consistent with the approach adopted under AIFMD, UCITS V provides that Member States shall require management companies to establish and apply remuneration policies and practices that are consistent with and promote sound and effective risk management and do not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the UCITS they manage and do not impair compliance with the management company's duty to act in the best interests of the UCITS.

The remuneration policies and practices will apply to those categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that falls within the remuneration bracket of senior management and risk takers whose professional activities have a material impact on the risk profiles of the management companies or of the UCITS they manage.

Following the introduction of UCITS V, UCITS managers' remuneration structures will be required to include:

- (i) criteria for calculating compensation for different categories of staff;
- (ii) a ban on guaranteed variable remuneration except in exceptional circumstances;
- (iii) rules for fixed and variable components of total remuneration (including a requirement that at least 50% of any variable remuneration is in the form of units of UCITS);
- (iv) rules on pension benefits; and
- (v) rules for payments related to early termination of employment (to ensure that failure is not rewarded).

UCITS managers will, however, have the flexibility to allow for the sound application of the remuneration policies in a manner proportionate to its size, its internal organisation as well as the nature, scale and complexity of its activities.

A new requirement in the final compromise text of the UCITS V Directive provides that details of the up to date remuneration policy (including a description of how remuneration and benefits are calculated, the identities of persons responsible for awarding the remuneration and benefits) will need to be disclosed in the Prospectus. Alternatively, the remuneration policy may be summarised in the Prospectus, provided a statement is included that further details of the policy are available by means of a website and that a paper copy is available to investors free of charge upon request (this information must also be disclosed in the Key Investor Information Document).

## 21.7 Regulatory Sanctions

Chapter XII of the existing UCITS Directive sets down broad principles relating to the supervisory and investigatory powers granted to the competent authorities of each Member State. It also provides that the measures and penalties to be imposed following infringements of the UCITS Directive are left to the discretion of each Member State.

An analysis of national rules on sanctions for breaches of the obligations of the UCITS Directive carried out by the Commission revealed that; (i) different fines were being imposed by Member States for the same category of breaches; (ii) different criteria were being applied by Member States in determining the amount of administrative sanctions; and (iii) there were variations in the use of sanctions by Member States. This resulted in the level of investor protection afforded to UCITS investors varying from Member State to Member State.

In order to address this inconsistency between Member States, UCITS V sets down an exhaustive list of actions which require sanction by competent authorities. It also sets out a minimum list of administrative sanctions and measures which may be applied in the event of any such breach, including prescriptive limits on fines which may be imposed by competent authorities. Prescriptive criteria to be taken into account when determining the type of administrative sanctions or measures to be taken by a competent authority are also set out.

## 21.8 UCITS VI

On 26 July, 2012, (only three weeks after the publication of the proposals in relation to UCITS V), the European Commission published a consultation paper entitled “Product Rules, Liquidity Management, Depositary, Money Market Funds, Long Term Investments”. It covers a number of UCITS-specific areas, including the treatment of OTC derivatives once the central clearing requirements for derivatives are in place, liquidity and redemption management by UCITS funds, but also goes further than UCITS in certain areas including the potential benefits of a depositary passport and how to attract long-term investment in Europe.

The consultation paper focuses on eight topics under consideration by the EU Commission and which may form the basis of a UCITS VI:

- (i) Eligible assets and use of derivatives: evaluation of the current practices in UCITS portfolio management and assessment of certain fund investment policies, in particular, the scope of assets and exposures that are deemed eligible for a UCITS fund;
- (ii) Efficient portfolio management techniques: assessment of current rules regarding certain types of techniques and instruments for the purposes of efficient portfolio management;
- (iii) Over the counter derivatives: treatment of OTC derivatives cleared through central counterparties and assessment of the current framework regarding operational risk and conflicts of interest;
- (iv) Extraordinary liquidity management rules: assessment of the potential need for uniform guidance in dealing with liquidity issues;
- (v) Depositary passport: currently there is no European passport for depositaries. The consultation paper assesses the possibility of introducing a cross border passport for the performance of the depositary function;

- (vi) Money Market Funds (“MMF”): assessment of the potential need to strengthen the resilience of the MMF market in order to prevent investor runs and systemic risks;
- (vii) Long term investments: assessment of the potential need for measures to promote long term investments and of the possible form of such measures (including investments in social entrepreneurship);
- (viii) Addressing UCITS IV: the EU Commission highlighted a number of areas as part of UCITS IV which need to be examined in light of the implementation of UCITS IV in July 2011.

Finally, the consultation considered further areas that may require alignment with the AIFMD. The Commission acknowledges that certain provisions are more detailed in the AIFMD in comparison to the UCITS Directive – in particular, the measures on organisational rules, delegation, risk and liquidity management rules, valuation, reporting or calculation of leverage.



## Appendix A Transferable Securities and Money Market Instruments

### A. Transferable Securities

#### (i) *UCITS IV Definitions*

The term “transferable securities” is defined in the UCITS IV Directive as being:

- (a) shares in companies and other securities equivalent to shares in companies (“shares”);
- (b) bonds and other forms of securitised debt (“debt securities”);
- (c) other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange;

other than the permitted UCITS efficient portfolio management techniques and instruments.

#### (ii) *Clarification by Eligible Asset Directive*

The Eligible Assets Directive clarifies the above definition by providing that the reference to transferable securities “shall be understood as a reference to financial instruments” which fulfill the following criteria:

- (a) the potential loss which the UCITS may incur with respect to holding those instruments is limited to the amount paid for them;
- (b) their liquidity does not compromise the ability of the UCITS to comply with its obligation to provide at least fortnightly redemption facilities;
- (c) reliable valuation is available for them as follows:
  - (i) in the case of securities admitted to or dealt in on a regulated market in the form of accurate, reliable and regular prices which are either market prices or prices made available by valuation systems independent from issuers;

- (ii) in the case of other securities (i.e. the aggregate 10% that can be invested in transferable securities and money market instruments not specifically referred to in Article 50(1)), in the form of a valuation on a periodic basis which is derived from information from the issuer of the security or from competent investment research;
- (d) appropriate information is available for them as follows:
  - (i) in the case of securities admitted to or dealt in on a regulated market as referred to in subparagraphs (a) to (d) of Article 50(1), in the form of regular, accurate and comprehensive information to the market on the security or, where relevant, on the portfolio of the security;
  - (ii) in the case of other securities as referred to in Article 50(2), in the form of regular and accurate information to the UCITS on the security or, where relevant, on the portfolio of the security;
- (e) they are negotiable;
- (f) their acquisition is consistent with the investment objectives or the investment policy, or both, of the UCITS;
- (g) their risks and their contribution to the overall risk profile of the portfolio are adequately captured by the risk management process of the UCITS which must be assessed on an ongoing basis.

For the purpose of subparagraphs (b) and (e), and unless there is information available to the UCITS that would lead to a different determination, financial instruments which are admitted or dealt in on a regulated market in accordance with Article 50(1) shall be presumed not to compromise the ability of the UCITS to comply with its redemption facility requirements and shall also be presumed to be negotiable.

For the purposes of subparagraph (b) above, where information is available to the UCITS that would lead it to determine that a transferable security could compromise the ability of the UCITS to comply with its redemption facility requirements, the UCITS must assess its liquidity risk.

The liquidity risk is a factor that the UCITS must consider when investing in any financial instrument in order to be compliant with the portfolio liquidity requirement to the extent required by its redemption facility requirements. In taking this prudent approach, the following are examples of the matters a UCITS may need to consider:

- (a) the volume and turnover in the transferable security;
- (b) if price is determined by supply and demand in the market, the issue size, and the portion of the issue that the asset manager plans to buy; also evaluation of the opportunity and timeframe to buy or sell;
- (c) where necessary, an independent analysis of bid and offer prices over a period of time may indicate the relative liquidity and marketability of the instrument, as may the comparability of available prices;
- (d) in assessing the quality of secondary market activity in a transferable security, analysis of the quality and number of intermediaries and market makers dealing in the transferable security concerned should be considered.

In the case of transferable securities which are not admitted to trading on a regulated market, liquidity cannot automatically be presumed. A UCITS, therefore, needs to assess the liquidity of such securities where this is necessary to meet the requirements of its redemption facility rules.

In the case of transferable securities which are not admitted to trading on a regulated market, negotiability similarly cannot automatically be presumed. The UCITS must assess the negotiability cannot automatically be presumed. The UCITS must assess the negotiability of securities held in the portfolio, with a view to ensuring compliance with the requirements of its redemption facility rules.

(iii) *Closed Ended Funds as Transferable Securities*

The Eligible Assets Directive clarifies that certain closed-ended funds will fall within the “transferable securities” definition and therefore be eligible for investment by UCITS as the term “transferable securities” includes:

- (a) units in closed-ended funds constituted as investment companies or as unit trusts, which fulfill the following criteria;

- (i) they fulfill the criteria set out in Section (ii) above titled “Clarification by Eligible Assets Directive” above;
  - (ii) they are subject to corporate governance mechanisms applied to companies;
  - (iii) where asset management activity is carried out by another entity on behalf of the closed ended fund, that entity is subject to national regulation for the purpose of investor protection.
- (b) units in closed-ended funds constituted under the law of contract which fulfill the following criteria:
- (i) they fulfill the criteria set out in Section (ii) above titled “Clarification by Eligible Assets Directive” above;
  - (ii) they are subject to corporate governance mechanisms equivalent to those applied to companies as referred to in subparagraph (a)(ii) above;
  - (iii) they are managed by an entity which is subject to national regulation for the purpose of investor protection.

In assessing whether the corporate governance mechanisms for closed ended funds in contractual form are equivalent to investment companies, the following factors are stated by the Central Bank to be indicators which can be used as a guidance:

Unitholders’ rights. The contract on which the fund is based should provide for:

- (i) right to vote of the unit holders in the essential decision making processes of the fund (including appointment and removal of asset management company, amendment to the contract which set up the fund, modification of investment policy, merger, liquidation);
- (ii) right to control the investment policy of the fund through appropriate mechanisms.

Segregation of assets. The assets of the fund should be separate and distinct from that of the asset manager and the fund must be subject to liquidation rules adequately protecting the unit holders.

A UCITS may not make investment in closed ended funds for the purposes of circumventing the normal UCITS investment limits.

(iv) *Structured Financial Instruments*

“Transferable securities” also include financial instruments which:

- (i) fulfill the criteria set out in Section (ii) titled “Clarification by Eligible Assets Directive” above;
- (ii) are backed by, or linked to the performance of, other assets, which may differ from those referred to in Article 50(1); provided that where a financial instrument covered by this subparagraph contains an embedded derivative component, the requirements regarding the derivatives risk management process, global exposure and aggregation of direct and indirect exposures shall apply to that component.

**B. Money Market Instruments**

This term means “*instruments normally dealt in on the money market which are liquid, and have a value which can be accurately determined at any time*”. These shall be understood by a reference to the following paragraphs:

- (i) financial instruments which are admitted to trading or dealt in on a regulated market (in accordance with subparagraphs (a), (b) and (c) of Article 50(1));
- (ii) financial instruments which are not admitted to trading.

The reference to money market instruments as “*instruments normally dealt in on the money market*” shall be understood as a reference to financial instruments which fulfil one of the following criteria:

- (a) they have a maturity at issuance of up to and including 397 days;
- (b) they have a residual maturity of up to and including 397 days;
- (c) they undergo regular yield adjustments in line with money market conditions at least every 397 days;

- (d) their risk profile, including credit and interest rate risks, corresponds to that of financial instruments which have a maturity as referred to in subparagraphs (a) or (b), or are subject to a yield adjustment as referred to in subparagraph (c).

The reference to money market instruments as “*instruments which are liquid*” shall be understood as a reference to financial instruments which can be sold at limited cost in an adequately short time frame, taking into account the obligation of the UCITS to repurchase or redeem its units at the request of any unit holder. When assessing the liquidity of a money market instrument, the following cumulative factors have to be taken into account:

At the instrument level:

- (i) frequency of trades and quotes for the instrument in question;
- (ii) number of dealers willing to purchase and sell the instrument, willingness of the dealers to make a market in the instrument in question, nature of market place trades (times needed to sell the instrument, method for soliciting offers and mechanics of transfer);
- (iii) size of issuance/program;
- (iv) possibility to repurchase, redeem or sell the money market instrument in a short period (e.g. seven business days), at limited cost, in terms of low fees and bid/offer prices and with very short settlement delay.

At the fund level, the following relevant factors should be considered in order to ensure that any individual money market instrument would not affect the liquidity of the UCITS at the fund level:

- (i) unit holder structure and concentration of unit holders of the UCITS;
- (ii) purpose of funding of unit holders;
- (iii) quality of information on the fund’s cash flow patterns;
- (iv) prospectuses’ guidelines on limiting withdrawals.

The fact that some of these conditions are not fulfilled does not automatically imply that the financial instruments should be considered as non-liquid. These elements must ensure that UCITS will have sufficient planning in the structuring of the portfolio and in foreseeing cash

flows in order to match anticipated cash flows with the selling of appropriately liquid instruments in the portfolio to meet those demands.

The reference to money market instruments as *“instruments which have a value which can be accurately determined at any time”* shall be understood as a reference to financial instruments for which accurate and reliable valuations systems, which fulfil the following criteria, are available:

- (i) they enable the UCITS to calculate a net asset value in accordance with the value at which the financial instrument held in the portfolio could be exchanged between knowledgeable willing parties in an arm’s length transaction;
- (ii) they are based either on market data or on valuation models including systems based on amortised costs.

With respect to the criterion *“value which can be accurately determined at any time”*, if the UCITS considers that an amortisation method can be used to assess the value of a money market instrument, it must ensure that this will not result in a discrepancy between the value of the money market instrument and the value calculated according to the amortisation method as set out in Guidance Note 1/08 UCITS: Valuation of assets of money market funds.

The criteria referred to above regarding liquidity and a valuation which can be accurately determined at any time shall be presumed to be fulfilled in the case of financial instruments which are normally dealt in on the money market and which are admitted to, or dealt in on, a regulated market in accordance with subparagraphs (a), (b) or (c) of Article 50(1), unless there is information available to the UCITS that would lead to a different determination. Where the presumption of “liquidity” and “accurate valuation” cannot be relied upon, the money market instrument should be subject to an appropriate assessment by the UCITS.

The reference in subparagraph (h) of Article 50(1) to money market instruments, other than those dealt in on a regulated market, provided that the issue or the issuer is itself regulated for the purpose of protecting investors and savings, shall be understood as a reference to financial instruments which fulfil the following criteria:

- (i) they fulfil one of the criteria set out in above regarding “instruments normally dealt in on the money market” and all the criteria set out above regarding “instruments which are liquid” and “value which can be accurately determined at any time”;
- (ii) appropriate information is available for them, including information which allows an appropriate assessment of the credit risks related to the investment in such

instruments, taking into account regulatory criteria applicable to transferable securities and money market instruments;

- (iii) they are freely transferable.

For money market instruments covered by sub-paragraphs (h)(ii) and (h)(iv) of Article 50(1) or for those which are issued by a local or regional authority of a Member State or by a public international body but are not guaranteed by a Member State or, in the case of a federal State which is a Member State, by one of the members making up the federation, appropriate information as referred to in paragraph (b) above shall consist of the following:

- (i) information on both the issue or the issuance programme and the legal and financial situation of the issuer prior to the issue of the money market instrument;
- (ii) updates of the information referred to in subparagraph (a) on an annual basis and whenever a significant event occurs;
- (iii) the information referred to in subparagraph (a) verified by appropriately qualified third parties not subject to instructions from the issuer. Such third parties should specialise in the verification of legal or financial documentation and be composed of persons meeting professional standards of integrity;
- (iv) available and reliable statistics on the issue or the issuance programme.

For the money instruments covered by subparagraph (h)(iii) of Article 50(1), appropriate information as referred to in paragraph (b) above shall consist of the following:

- (i) information on the issue or the issuance programme or on the legal and financial situation of the issuer prior to the issue of the money market instrument;
- (ii) updates of the information referred to in subparagraph (a) on a regular basis and whenever a significant event occurs;
- (iii) available and reliable statistics on the issue or issuance programme or other data enabling an appropriate assessment of the credit risks related to the investment in such instruments.

For all the money market instruments covered by subparagraph (h)(i) of Article 50(1), except those referred to in the category above covered by sub-paragraphs h(ii) and (h)(iv) etc. and those issued by the European Central Bank or by a central bank from a Member State,

appropriate information as referred to in paragraph (b) above shall consist of information on the issue or the issuance programme or on the legal and financial situation of the issuer prior to the issue of the money market instrument.

The reference in subparagraph (h)(iii) of Article 50(1) to an establishment which is subject to and complies with prudential rules considered by the Central Bank to be at least as stringent as those laid down by Community law shall be understood as a reference to an issuer which is subject to and complies with prudential rules and fulfils one of the following criteria:

- (i) it is located in the European Economic Area;
- (ii) it is located in the OECD countries belonging to the Group of Ten;
- (iii) it has at least investment grade rating;
- (iv) it can be demonstrated on the basis of an in-depth analysis of the issuer that the prudential rules applicable to that issuer are at least as stringent as those laid down by Community law.

The reference in subparagraph (h)(iv) of Article 50(1) to securitisation vehicles shall be understood as a reference to structures, whether in corporate, trust or contractual form, set up for the purpose of securitisation operations.

The reference in subparagraph (h)(iv) of Article 50(1) to banking liquidity lines shall be understood as a reference to banking facilities secured by a financial institution which itself complies with the subparagraph (h)(iii) of Article 50(1).



## **Appendix B**

### **UCITS Investment and Borrowing Restrictions**

#### **1 Permitted Investments**

Investments of a UCITS are confined to:

- 1.1 Transferable securities and money market instruments, as prescribed in the UCITS Notices, which are either admitted to official listing on a stock exchange in a Member State or non-Member State or which are dealt on a market which is regulated, operates regularly, is recognised and open to the public in a Member State or non-Member State.
- 1.2 Recently issued transferable securities which will be admitted to official listing on a stock exchange or other market (as described above) within a year.
- 1.3 Money market instruments, as defined in the UCITS Notices, other than those dealt on a regulated market.
- 1.4 Units of UCITS.
- 1.5 Units of non-UCITS as set out in the Central Bank's Guidance Note 2/03.
- 1.6 Deposits with credit institutions as prescribed in the UCITS Notices.
- 1.7 Financial derivative instruments as prescribed in the UCITS Notices.

#### **2 Investment Restrictions**

- 2.1 A UCITS may invest no more than 10% of net assets in transferable securities and money market instruments other than those referred to in paragraph 1.
- 2.2 A UCITS may invest no more than 10% of net assets in recently issued transferable securities which will be admitted to official listing on a stock exchange or other market (as described in paragraph 1.1) within a year. This restriction will not apply in relation to investment by the UCITS in certain US securities known as Rule 144A securities provided that:
  - the securities are issued with an undertaking to register with the US Securities and Exchanges Commission within one year of issue; and

- the securities are not illiquid securities i.e. they may be realised by the UCITS within seven days at the price, or approximately at the price, at which they are valued by the UCITS.
- 2.3 A UCITS may invest no more than 10% of net assets in transferable securities or money market instruments issued by the same body provided that the total value of transferable securities and money market instruments held in the issuing bodies in each of which it invests more than 5% is less than 40%.
- 2.4 The limit of 10% (in 2.3) is raised to 25% in the case of bonds that are issued by a credit institution which has its registered office in a Member State and is subject by law to special public supervision designed to protect bond-holders. If a UCITS invests more than 5% of its net assets in these bonds issued by one issuer, the total value of these investments may not exceed 80% of the net asset value of the UCITS. **This restriction need not be included unless it is intended to avail of this provision and reference must be made to the fact that this requires the prior approval of the Central Bank.**
- 2.5 The limit of 10% (in 2.3) is raised to 35% if the transferable securities or money market instruments are issued or guaranteed by a Member State or its local authorities or by a non-Member State or public international body of which one or more Member States are members.
- 2.6 The transferable securities and money market instruments referred to in 2.4 and 2.5 shall not be taken into account for the purpose of applying the limit of 40% referred to in 2.3.
- 2.7 A UCITS may not invest more than 20% of net assets in deposits made with the same credit institution.

Deposits with any one credit institution, other than

- (i) a credit institution authorised in the EEA (European Union Member State, Norway, Iceland, Liechtenstein);
- (ii) a credit institution authorised within a signatory state (other than an EEA Member State) to the Basle Capital Convergence Agreement of July 1988 (Switzerland, Canada, Japan, United States); or
- (iii) a credit institution authorised in Jersey, Guernsey, the Isle of Man, Australia or New Zealand

held as ancillary liquidity, must not exceed 10% of net assets. This limit may be raised to 20%

in the case of deposits made with the trustee/custodian.

- 2.8 The risk exposure of a UCITS to a counterparty to an OTC derivative may not exceed 5% of net assets.

This limit is raised to 10% in the case of a credit institution authorised in the EEA; a credit institution authorised within a signatory state (other than an EEA Member State) to the Basle Capital Convergence Agreement of July 1988; or a credit institution authorised in Jersey, Guernsey, the Isle of Man, Australia or New Zealand.

- 2.9 Notwithstanding paragraphs 2.3, 2.7 and 2.8 above, a combination of two or more of the following issued by, or made or undertaken with, the same body may not exceed 20% of net assets:

- investments in transferable securities or money market instruments;
- deposits, and/or
- risk exposures arising from OTC derivatives transactions.

- 2.10 The limits referred to in 2.3, 2.4, 2.5, 2.7, 2.8 and 2.9 above may not be combined, so that exposure to a single body shall not exceed 35% of net assets.

- 2.11 Group companies are regarded as a single issuer for the purposes of 2.3, 2.4, 2.5, 2.7, 2.8 and 2.9. However, a limit of 20% of net assets may be applied to investment in transferable securities and money market instruments within the same group.

- 2.12 A UCITS may invest up to 100% of net assets in different transferable securities and money market instruments issued or guaranteed by any Member State, its local authorities, non-Member States or public international body of which one or more Member States are members.

The individual issues must be listed in the prospectus and may be drawn from the following list:

OECD Governments (provided the relevant issues are investment grade), Government of the People's Republic of China, Government of Brazil (provided the issues are of investment grade), Government of India (provided the issues are of investment grade), Government of Singapore, European Investment Bank, European Bank for Reconstruction and Development, International Finance Corporation, International Monetary Fund, Euratom, The Asian Development Bank, European Central Bank, Council of Europe, Eurofima, African Development Bank, International Bank for Reconstruction and Development (The World Bank), The Inter American Development Bank, European Union, Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac), Government National Mortgage Association (Ginnie Mae), Student Loan Marketing Association

(Sallie Mae), Federal Home Loan Bank, Federal Farm Credit Bank, Tennessee Valley Authority, Straight-A Funding LLC, Export-Import Bank.

The UCITS must hold securities from at least 6 different issues, with securities from any one issue not exceeding 30% of net assets.

### **3 Investment in Collective Investment Schemes (“CIS”)**

- 3.1 A UCITS may not invest more than 20% of net assets in any one CIS.
- 3.2 Investment in non-UCITS may not, in aggregate, exceed 30% of net assets.
- 3.3 The CIS are prohibited from investing more than 10% of net assets in other open-ended CIS.
- 3.4 When a UCITS invests in the units of other CIS that are managed, directly or by delegation, by the UCITS management company or by any other company with which the UCITS management company is linked by common management or control, or by a substantial direct or indirect holding, that management company or other company may not charge subscription, conversion or redemption fees on account of the UCITS investment in the units of such other CIS.
- 3.5 Where a commission (including a rebated commission) is received by the UCITS’ manager / investment manager / investment adviser by virtue of an investment in the units of another CIS, this commission must be paid into the property of the UCITS.

### **4 Index Tracking UCITS**

- 4.1 A UCITS may invest up to 20% of net assets in shares and/or debt securities issued by the same body where the investment policy of the UCITS is to replicate an index which satisfies the criteria set out in the UCITS Notices and is recognised by the Central Bank
- 4.2 The limit in 4.1 may be raised to 35%, and applied to a single issuer, where this is justified by exceptional market conditions.

### **5 General Provisions**

- 5.1 An investment company, ICAV or management company acting in connection with all of the CIS it manages, may not acquire any shares carrying voting rights which would enable it to exercise significant influence over the management of an issuing body.

5.2 A UCITS may acquire no more than:

- (i) 10% of the non-voting shares of any single issuing body;
- (ii) 10% of the debt securities of any single issuing body;
- (iii) 25% of the units of any single CIS;
- (iv) 10% of the money market instruments of any single issuing body.

NOTE: The limits laid down in (ii), (iii) and (iv) above may be disregarded at the time of acquisition if at that time the gross amount of the debt securities or of the money market instruments, or the net amount of the securities in issue cannot be calculated.

5.3 5.1 and 5.2 shall not be applicable to:

- (i) transferable securities and money market instruments issued or guaranteed by a Member State or its local authorities;
- (ii) transferable securities and money market instruments issued or guaranteed by a non-Member State;
- (iii) transferable securities and money market instruments issued by public international bodies of which one or more Member States are members;
- (iv) shares held by a UCITS in the capital of a company incorporated in a non-member State which invests its assets mainly in the securities of issuing bodies having their registered offices in that State, where under the legislation of that State such a holding represents the only way in which the UCITS can invest in the securities of issuing bodies of that State. This waiver is applicable only if in its investment policies the company from the non-Member State complies with the limits laid down in 2.3 to 2.11, 3.1, 3.2, 5.1, 5.2, 5.4, 5.5 and 5.6, and provided that where these limits are exceeded, paragraphs 5.5 and 5.6 below are observed.
- (v) Shares held by an investment company or investment companies or ICAV or ICAVs in the capital of subsidiary companies carrying on only the business of management, advice or marketing in the country where the subsidiary is located, in regard to the repurchase of units at unitholders' request exclusively on their behalf.

5.4 UCITS need not comply with the investment restrictions herein when exercising subscription

rights attaching to transferable securities or money market instruments which form part of their assets.

- 5.5 The Central Bank may allow recently authorised UCITS to derogate from the provisions of 2.3 to 2.12, 3.1, 3.2, 4.1 and 4.2 for six months following the date of their authorisation, provided they observe the principle of risk spreading.
- 5.6 If the limits laid down herein are exceeded for reasons beyond the control of a UCITS, or as a result of the exercise of subscription rights, the UCITS must adopt as a priority objective for its sales transactions the remedying of that situation, taking due account of the interests of its shareholders.
- 5.7 Neither an investment company, ICAV nor a management company or a trustee acting on behalf of a unit trust or a management company of a common contractual fund, may carry out uncovered sales of:
- transferable securities;
  - money market instruments;\*
  - units of CIS; or
  - financial derivative instruments.

[\* any short selling of money market instrument by UCITS is prohibited.]

- 5.8 A UCITS may hold ancillary liquid assets.

## **6 Financial Derivative Instruments ('FDIs')**

- 6.1 A UCITS global exposure (as prescribed in the UCITS Notices) relating to FDI must not exceed its total net asset value.
- 6.2 Position exposure to the underlying assets of FDI, including embedded FDI in transferable securities or money market instruments, when combined where relevant with positions resulting from direct investments, may not exceed the investment limits set out in the UCITS Notices. (This provision does not apply in the case of index based FDI provided the underlying index is one which meets with the criteria set out in the UCITS Notices.)
- 6.3 A UCITS may invest in FDIs dealt in over-the-counter (OTC) provided that The counterparties to over-the-counter transactions (OTCs) are institutions subject to prudential supervision and belonging to categories approved by the Central Bank.

6.4 Investment in FDIs are subject to the conditions and limits laid down by the Central Bank

## **7 Restrictions on Borrowing and Lending**

7.1 A UCITS may borrow up to 10% of its Net Asset Value provided such borrowing is on a temporary basis. A UCITS may charge its assets as security for such borrowings.

7.2 A UCITS may acquire foreign currency by means of a “back to back” loan agreement. Foreign currency obtained in this manner is not classified as borrowing for the purposes of the borrowing restrictions set out at (a) above provided that the offsetting deposit:

- (i) is denominated in the base currency of the UCITS; and
- (ii) equals or exceeds the value of the foreign currency loan outstanding.



## Appendix C UCITS Management Company Authorisation Options

### UCITS Management Companies are able to carry out the following activities:

1. the management of unit trusts/common funds and of investment companies (*collective portfolio management*). This includes:
  - (a) Investment management
  - (b) Administration:
    - legal and fund management accounting services
    - customer enquiries
    - valuation and pricing (including tax returns)
    - regulatory compliance monitoring
    - maintenance of unitholder register
    - distribution of income
    - unit issues and redemptions
    - contract settlements (including certificate dispatch)
    - record keeping
  - (c) Marketing
- 2.2 (i) management of portfolios of investments, including those owned by pension funds in accordance with mandates given by investors on a discretionary client-by-client basis (*individual portfolio management*), where such portfolios including one or more of the instruments listed in Section B of the Annex to the Investment Services Directive;
- 2.3 (i) as non-core services:
  - (a) investment advice concerning one or more of the instruments listed in Section B of the Annex to the Investment Services Directive
  - (b) safekeeping and administration in relation to units of collective investment undertakings

It is important to note however that Management Company may not be authorised solely to provide the services referred to in 2.2 (a) or (b) and, furthermore, may only be authorised to

provide the non-core services referred to in 2.2 (b) where they are authorised for activity 2.2 (a).

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