# Funds Quarterly Legal and Regulatory Update

**Period covered:**
**1 October 2012 to 31 December 2012**

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# FUNDS QUARTERLY LEGAL AND REGULATORY UPDATE

## UCITS, Non-UCITS & Hedge Funds

### (i) UCITS self-managed investment companies

*Background*

On 30 November, 2012 the Central Bank of Ireland (the “Central Bank”) announced that it will begin accepting submissions of the revised Directive 2009/65/EC (“UCITS IV”) compliant business plans for self-managed investment companies (“SMICs”) in three separate tranches in 2013.

The three tranches are: 31 January 2013, 31 March 2013 and 31 May 2013. The Central Bank has asked the law firms acting for the SMICs to split their SMIC client list over the three tranches so as to avoid a situation whereby the vast majority of the SMIC applications are not left until 31 May 2013. All new SMIC applications from 1 January 2013 will be required to comply in full with the UCITS IV requirements.

*UCITS IV Requirements for SMICs*

In terms of what SMICs can be expected to have to comply with under UCITS IV and document accordingly in their business plans, the Central Bank has previously clarified in a letter to the industry on 10 August, 2012 that both UCITS management companies and SMICs should be subject to the same basic regime under UCITS IV bearing in mind the ‘nature, scale and complexity’ of the SMIC.

At a high level, we can take from this that while all of the requirements of UCITS IV should apply to SMICs, on the basis that most are less complex than UCITS management companies, the implementation of the full requirements should be considered in light of the ‘nature, scale and complexity’ of the SMICs and any decision not to implement any of the requirements must be capable of justification on that basis. In addition, it is worth noting that the Central Bank has advised that the requirement to have a permanent compliance function and a permanent internal audit function will not apply to SMICs.

The Central Bank has confirmed that a revised version of the UCITS management company application form (which also applies to SMIC authorisations) containing these updated requirements will be issued by 1 January, 2013.

*Filing Process*

The submitted business plans will be reviewed by the Central Bank on a spot check basis.

While the Central Bank will not issue individual confirmation of receipt for submitted business plans, a list will be issued to the law firm at the end of each tranche noting the revised business plans that have been received. Provided no correspondence has been received by the SMIC (for example with comments arising as a result of a spot check) the Central Bank has stated that the SMIC can assume that their business plans and ancillary documents are in order.

**(ii) IFIA publish response to UCITS VI proposals**

On 26 July, 2012 the European Commission (the "Commission") published a consultation paper entitled "Product Rules, Liquidity Management, Depositary, Money Market Funds, Long Term Investments" (the "Consultation Paper"). The Consultation Paper focuses on eight topics under consideration by the Commission and which may form the basis of a UCITS VI. It does not address and is separate to the proposals concerning the UCITS depositary, remuneration and administrative sanctions commonly referred to as UCITS V. The areas considered by UCITS VI mirror those which have been recently considered by ESMA in their guidelines for UCITS ETFs and UCITS generally.

The consultation focuses on eight key topics;

1. *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;

2. *Efficient portfolio management techniques:* assessment of current rules regarding certain types of techniques and instruments for the purposes of efficient portfolio management;

3. *Over the counter (OTC) derivatives:* treatment of OTC derivatives cleared through central counterparties and assessment of the current framework regarding operational risk and conflicts of interest;

4. *Extraordinary liquidity management rules*: assessment of the potential need for uniform guidance in dealing with liquidity issues;

5. *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;

6. *Money Market Funds (MMFs):* assessment of the potential need to strengthen the resilience of the MMF market in order to prevent investor runs and systemic risks;

7. *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); and

8. *Addressing UCITS IV:* the Commission has highlighted a number of areas as part of UCITS IV which need to be examined following the implementation of UCITS IV in July 2011.

The IFIA published its response to the Consultation Paper on 19 October, 2012 which addressed the eight topics listed above. The IFIA's response may be found here: http://www.irishfunds.ie/fs/doc/IFIA_response_to_UCITS_Consultation_Document__18_October_2012_Final.pdf

The Commission published a UCITS VI Roadmap in October, 2012 which provides additional background information to the Consultation Paper. The Roadmap may be viewed here: http://ec.europa.eu/governance/impact/planned_ia/docs/2013_markt_010_revision_of_ucits_en.pdf

### (iii) ESMA publish 'Guidelines on Exchange Traded Funds ("ETFs") and other UCITS issues'

*Introduction*

On 18 December, 2012 European Securities and Markets Authority ("ESMA") officially published its Guidelines on ETFs and other UCITS issues (the "Guidelines"). This publication marks the beginning of the two month period during which national supervisors have to declare to ESMA their compliance with the Guidelines or explain the reason for non-compliance. The end of this two month period shall be the "Effective Date" from which the Guidelines will apply.

This publication consolidates the Guidelines on ETFs and other UCITS issues (ESMA/2012/474) and the Guidelines on repo and reverse repurchase agreements (ESMA/2012/722), published earlier this year. The Central Bank intends to enforce the Guidelines through amended UCITS Notices which are intended to be issued before the Effective Date.

Some of the provisions of the Guidelines will apply immediately after the Effective Date and some of the provisions will be subject to transitional provisions. Most of the transitional provisions give twelve months from the Effective Date to comply but some of the provisions can apply before then if for example fund documentation is being updated after the Effective Date for other purposes.

The purpose of the Guidelines is to strengthen investor protection by providing guidance on the information which should be communicated with respect to Index-Tracking UCITS and UCITS ETFs together with specific rules to be applied by UCITS when entering into OTC derivative transactions and when applying efficient portfolio management techniques.

*ESMA guidelines on repo and reverse repurchase agreements for UCITS funds*

ESMA published guidelines on repo and reverse agreements on 4 December, 2012 following a consultation process (the "Repo Guidelines"). As outlined above the Repo Guidelines have been incorporated into the Guidelines. The aim of the Repo Guidelines is to protect investors by introducing requirements on the use of repo and reverse repurchase agreements by UCITS.

The Repo Guidelines provide that a UCITS should enter into repo agreements on terms that allow the UCITS to recall any assets for the full amount of cash at any time. For UCITS entering into reverse repo agreements, the Repo Guidelines leave the possibility for the cash to be recalled on an accrued basis or on a mark-to-market basis. However, if cash is recallable on a mark-to-market basis, the UCITS should value the reverse repo on a mark-to-market basis. Fixed term repo and reverse repurchase agreements that do not exceed seven days should be considered as arrangements on terms that allow the assets to be recalled at any time by the UCITS. This change should enhance the existing UCITS Notice 12 regime for repurchase/reverse repurchase agreements and stock lending and it is anticipated that the UCITS Notices will be updated accordingly in the coming months.

The Repo Guidelines introduce express requirements in relation to recallability, which aim to protect investors by limiting the possibility of repo and repurchase arrangements compromising the ability of a UCITS to meet redemption requests.

The Guidelines may be viewed here; http://www.esma.europa.eu/system/files/esma_en.pdf

**(iv) ESMA Opinion on its Interpretation of Article 50(2)(a) of the UCITS Directive**

On November 20, 2012 ESMA published a formal opinion on its interpretation of Article 50(2)(a) of the UCITS Directive (*2009/65/EC*) ("UCITS Directive") which may have implications for UCITS which hold units or shares of collective investment schemes within the 10% limit provided for in Article 50 (2)(a), commonly referred to as the "trash bucket".

Article 50(2)(a) of the UCITS Directive provides that UCITS may not invest more than 10% of their 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).

ESMA's opinion states that UCITS may only invest in units or shares of collective investment undertakings as defined in Article 50(1)(e) of the UCITS Directive, being other UCITS and other collective investment undertakings, whether or not established in a Member State, which meet the following criteria:

- they are authorised under laws which provide that they are subject to supervision considered by the competent authority of the UCITS home Member State to be equivalent to that laid down in EU law, and that co-operation between authorities is sufficiently assured;
- the level of protection for unit holders is equivalent to that provided for unit holders in a UCITS, and in particular the rules on asset segregation, borrowing, lending and uncovered sales of transferable securities and money market instruments are equivalent to the UCITS Directive requirements;
- the business is reported on in half yearly and annual reports; and
- no more than 10% of the assets of the UCITS or other collective investment undertakings can, according to their constitutive documents, be invested in aggregate in units of other UCITS or other collective investment undertakings.

ESMA's opinion points to the fact that Article 50(2)(a) refers only to investments in transferable securities and money market instruments and not to units or shares of collective investment undertakings, and accordingly it follows that the derogation provided in Article 50(2)(a) does not extend to units or shares of collective investment undertakings.

ESMA expects that any portfolio adjustments required to ensure compliance with this opinion will be made taking into account the best interest of investors and at the latest by 31 December, 2013.

ESMA's competence to deliver an opinion is based on Article 29(1) (a) of Regulation (EC) No 1095/2010. Whilst such opinions are not binding, there is an expectation that such opinions will be adopted by competent authorities into local rules. Where a competent national authority does not comply with an opinion issued by ESMA, ESMA does have authority to initiate further procedures to ensure common, uniform and consistent application of EU law by national competent authorities. Accordingly, we await the Central Bank's official position in respect of ESMA's opinion.

However, there are at least two areas of concern with this opinion. Firstly, it appears to create a potential conflict between ESMA's opinion and the Eligible Assets Directive (Directive 2007/16/EC) insofar as it relates to closed-ended collective investment schemes. The Eligible Assets Directive has made it clear that certain closed-ended funds will fall within the definition of "transferable securities" and therefore be eligible for investment by UCITS subject to meeting certain criteria. In other words, they are funds but they qualify as transferable securities.

Secondly, ESMA's opinion suggests that the treatment of certain Non-UCITS ETFs (including those from outside the EU) as transferable securities would not be acceptable, which could exclude them entirely from a UCITS investment menu.

These areas may warrant further consideration of this opinion.

In conclusion, ESMA’s opinion calls for limits on the scope of the “trash bucket”, which means UCITS portfolio managers will need to carefully consider the composition of their portfolios in future, particularly holdings of units or shares in collective investment undertakings which do not meet the criteria outlined in Article 50(1)(e).

**(v) The International Organisation of Securities Commissions ("IOSCO") Policy Recommendations for Money Market Funds (“MMFs”)**

On 9 October 2012, IOSCO published its final report on policy recommendations and proposes fifteen recommendations as a basis for common standards globally for the negotiation of MMFs. The report follows a consultation in April, 2012 (IOSCO – Money Market Fund Systemic Risk Analysis and Reform Options). It is likely that the Commission will want to adopt IOSCOs proposals and in this regard it is likely that the Commission will issue a consultation paper in this area in 2013.

The final report may be viewed here; http://www.iosco.org/library/pubdocs/pdf/IOSCOPD392.pdf

## Alternative Investment Fund Managers Directive ("AIFMD")

**(i) Commission publishes Level 2 Regulation on AIFMD**

On 19 December, 2012, the Commission published its Level 2 measures on AIFMD which flesh out the rules for Alternative Investment Fund Managers ("AIFMs") in accordance with the AIFMD.

The Level 2 measures, formally a Commission Delegated Regulation, supplements AIFMD in a number of areas dealing in particular with operating conditions, organisational requirements, valuation rules, rules concerning the delegation of AIFM functions, depositaries' responsibilities and liabilities as well as capitalisation and own funds requirements for AIFMs and ancillary matters.

The Level 2 measures are now subject to a three month scrutiny period by the European Parliament and the Council and, unless either objects, will enter into force at the end of the three month period following publication in the Official Journal.

The level 2 measures will be directly effective in each EU Member State and therefore will not require any implementing measures to be adopted by national legislators or regulators.

**(ii) Revised Alternative Investment Funds handbook expected to be published in January 2013**

AIFMD sets out rules which will apply to all alternative investment fund managers from 22 July, 2013. In Ireland, AIFMD will be transposed into law by means of secondary legislation. The Central Bank has taken this opportunity to review, consolidate and simplify the existing regulation of non-UCITS investment funds into a single "AIF Handbook". This new draft handbook formed the basis of consultation paper (CP 60) on the implementation of AIFMD in Ireland and was published by the Central Bank on 30 October, 2012.

It is interesting to note that the format of the new handbook is different to the regime that is currently in place in that it does not contain any guidance but instead contains prescriptive language as to what can/cannot be done.

The Central Bank asked stakeholders for their views on the following proposals in CP60;

- Discontinuation of the Professional Investor Fund (PIF) regime;

- Removal of the promoter regime (which includes the promoter approval application and capital requirements). The Central Bank will place reliance instead on the AIFM taking into account the obligations which AIFMD imposes on the AIFM;

- Removal of a number of requirements which currently apply to Qualifying Investor Funds (QIFs) which do not substantially increase investor protection;
- Changes to the prime brokerage provisions which are currently contained in the Central Bank's Prime Broker Guidance Note;
- Measures to facilitate property and private equity funds;
- Provision for fair as opposed to equal treatment of investors in different share classes;
- Greater flexibility around side pockets;
- The introduction of Retail Investor Alternative Investor Fund.

The consultation period for CP 60 closed on 11 December 2012 and it is hoped that the AIF Handbook will be put in place in early 2013.

**(iii) ESMA Consultation Paper on Draft regulatory technical standards on types of AIFMs**

ESMA published a consultation paper entitled "Draft regulatory technical standards on types of AIFMs on 19 December, 2012. Article 4(4) of AIMFD provides that ESMA shall develop draft regulatory technical standards ("RTS") to determine types of Alternative Investment Fund Managers ("AIFMs"), where relevant in the application of AIFMD and to ensure uniform conditions on the application of AIFMD. ESMA published a discussion paper on the key concepts of AIFMD and the types of AIFM on 23 February, 2012 (the "Discussion Paper") and the Discussion Paper represented the first step in the elaboration of the draft RTS under Article 4(4) of AIFMD. It is intended the draft RTS should be aimed at determining the types of AIFM covered by AIFMD, thereby allowing appropriate differentiation of the requirements according to the nature of the entity.

The questions posed in the draft RTS can be summarised as follows;

1. Do you agree with the approach taken by ESMA on the topics which are included in the draft RTS?
2. Do you agree with the proposed definition of AIFM of open ended/closed ended Alternative Investment Funds ("AIFs")?
3. Can you provide qualitative and quantitative data on the costs and benefits that the proposed definition of AIFMs of open ended/closed ended AIFs would imply?
4. Do you consider that any possibility to redeem the AIFs units/shares on the secondary market and not directly from the AIF should be taken into consideration when assessing whether AIFM is and AIFM of open ended or closed ended AIFs? Alternatively do you consider (that as within the UCITS framework) only an action taken by an AIFM to ensure that the stock

exchange value of the units of the AIF it manages does not significantly vary from their net assets value should be regarded as equivalent to granting to unitholders/shareholders the right to redeem their units or shares out of the assets of this AIF?

5. Do you agree with the proposed approach as regards the treatment of hybrid structures?
6. Do you consider merit in clarifying further the notion of contracts with prime brokers?
7. Do you consider that there is a need to develop further typologies of AIFMS in the application of AIFMD?

ESMA has invited comments on the draft RTS and responses should be submitted by 1 February, 2013 online at www.esma.europa.eu under the heading "Your input – Consultations". All contributions received will be published following the close of the consultation period unless ESMA receives a request that a response should not be published. It is hoped that any response received will help ESMA to finalise the draft RTS to be submitted to the Commission in the first half of 2013 for endorsement.

It is likely that this consultation will be of particular relevance those who wish to avoid being the subject of AIFMD.

**(iv) ESMA Consultation Paper "Consultation on guidelines on key concepts of AIFMD"**

ESMA published a consultation paper entitled "Guidelines on key concepts of the AIFMD" on 19 December, 2012 (the "draft Guidelines"). This draft Guidelines set out formal proposals for guidelines ensuring common, uniform and consistent application of the concepts of "AIF" which is contained in Article 4(1)(a) of AIFMD by providing clarification on these concepts. ESMA has stated that it is necessary to have a clear understanding of which entity is the AIFM which depends on a harmonised approach as to what constitutes an AIF.

The questions posed in the draft Guidelines can be summarised as follows;

1. Do you agree with the approach taken by ESMA on the topics which are included in the draft Guidelines?
2. What are your views on the concepts used in the definition of AIF in AIFMD? Do you agree with the criteria identified by ESMA for defining an AIF?
3. Do you agree with the views expressed by ESMA on the concept of "raising capital"?
4. Can you provide qualitative and quantitative data on the on the costs and benefits that the proposed guidance on the notion of raising capital would imply?
5. Do you agree with the proposed guidance for identifying a "collective investment undertaking" for the purposes of the definition of AIF?
6. Can you provide qualitative and quantitative data on the costs and benefits that the proposed guidance for identifying a "collective investment undertaking" would imply?

7. Do you agree with the analysis on the absence of any day-to-day investor discretion or control of the underlying assets in an AIF?
8. Do you agree that an ordinary company with general commercial purpose should not be considered a collective investment undertaking?
9. What are the key characteristics defining an ordinary company with general commercial purpose?
10. Do you agree with the proposed guidance for determining whether a "number of investors" exists for the purposes of the definition of AIF?
11. Can you provide qualitative and quantitative data on the costs and benefits that the proposed guidance for determining whether a "number of investors" exists would imply?
12. Do you agree with the proposed indicative criteria for determining whether a "defined investment policy" exists for the purposes of the definition of AIF?

ESMA has invited comments on the draft Guidelines and responses should be submitted by 1 February, 2013 online at www.esma.europa.eu under the heading "Your input – Consultations". All contributions received will be published following the close of the consultation period unless ESMA receives a request that a response should not be published. It is hoped that any response received will help ESMA to finalise guidelines on the key concepts of AIFMD in the first half of endorsement.

**(v) EU and Swiss regulators to co-operate on cross-border supervision of AIFs**

ESMA approved the co-operation arrangements between the Swiss Financial Market Supervisory Authority FINMA and the EU securities regulators for the supervision of AIFs including hedge funds, private equity and real estate funds on 3 December, 2012. ESMA negotiated the agreement with FINMA on behalf of all 27 EU national competent authorities for securities markets regulation. The agreement will take the form of a Memorandum of Understanding (MoU) between the EU securities supervisors and FINMA.

The co-operation arrangements include the exchange of information, cross-border on-site visits and mutual assistance in the enforcement of the respective supervisory laws. This co-operation will apply to Swiss AIFMs that manage or market AIFs in the EU and to EU AIFMs that manage or market AIFs in Switzerland.

The agreement also covers co-operation in the cross-border supervision of depositaries and AIFMs' delegates.

## MiFID

**(i) MiFID II**

In December 2010, the Commission published a consultation paper relating to proposed amendments to MiFID. Following that consultation process, the Commission published draft legislative proposals in the form of a draft Directive and a draft Regulation, referred to together as the "draft MiFID II Legislation" in October 2011. The draft MiFID II Legislation includes potentially comprehensive reforms to the existing regulatory regime. The proposals introduce a range of measures which seek to address deficiencies in the MiFID regime exposed by the financial crisis. It focuses in particular on addressing problems that have arisen from the expansion in OTC trading in comparison with trading on exchanges and the related issue of transparency of such trading. MiFID II carries fundamental implications for the nature and shape of financial markets by shifting trading from the more opaque OTC market to more transparent organised markets.

In addition custody services (safekeeping and administration of financial instruments for the account of clients), which were previously classified as ancillary services will now become a core investment service, which will bring standalone custodians in Ireland within scope of the MiFID Regulations (as opposed to falling to be regulated under the Investment Intermediaries Act 1995 as is currently the case).

The proposals contained in the draft MiFID II Legislation are comprehensive and represent significant changes to the regulatory regime currently in place in Ireland. The draft MiFID II Legislation is divided into two parts;

(i) a revised Directive which will be an amendment and restatement of MiFID, (the "MiFID II Directive"); and

(ii) a new Regulation which will set out requirements relating to trade transparency and the mandatory trading of derivatives on organised venues, (the "MiFID II Regulation"). EU Regulations take effect as soon as they are published by the Commission and are binding on all EU Member States as soon as they become effective. EU Regulations do not require any implementing measures. It is hoped that the MiFID II Regulation will minimise any scope for divergences in the interpretation of transparency and transaction reporting provisions.

ESMA has been asked to draft accompanying technical standards, (the "Technical Standards") which as yet have not been published. The full extent of the proposed changes will not be possible to assess until such time as the Technical Standards are published. Furthermore it is likely that additional changes will be made to the draft MiFID II Legislation as it is negotiated between the Commission, European Parliament and the European Council.

The time line for implementation of MiFID II is still not clear. The Commissions draft MiFID II Legislation is still at the trilogue stage; this is the process by which the Commission, the European Parliament and the Council of the European Union discuss, amend and adopt the final text of legislation. The Presidency of the Council of the European Union published a compromise proposal on the proposed MiFID II Directive and a compromise proposal on the proposed MiFID II Regulation on 3 December 2012.

Once the draft MiFID II Legislation has been agreed by the Commission, the European Parliament and the Council of the European Union will be published in the Official Journal. Some of the proposals will apply immediately after publication in the Official Journal and others will not be effective until they have been transposed into the national law of the Member States.

More detailed implementing measures to be prepared by the Commission (i.e. Level 2 measures) which will serve to supplement the Level 1 draft MiFID II Legislation are expected to be finalised in early 2014. It is expected that the deadline for enacting legislation in Member States implementing the draft MiFID II Directive will be subsequent to this. In addition the draft implementing Technical Standards (i.e. Level 3 measures) which are to be submitted to the Commission by ESMA are expected to be finalised in 2016.

## Short Selling Regulation

Regulation (EU) No. 236/2012 of the European Parliament and of Council on short selling and certain aspects of credit default swaps (the "EU Short Selling Regulation") was published in the Official Journal on 24 March, 2012 and came into operation on 1 November, 2012. The EU Short Selling Regulation could have implications for investment managers who are involved in the short selling of EU listed shares or sovereign debt.

The EU Short Selling Regulation; (i) requires persons (both legal and natural) to disclose net short positions in EU listed shares and EU sovereign debt[1]; (ii) restricts uncovered short sales of EU listed shares and EU sovereign debt; (iii) prohibits uncovered credit default swaps ("CDS") in EU sovereign debt which broadly speaking does not serve to hedge against exposure to the underlying sovereign debt; (iv) requires central counterparties that provide clearing services for shares to ensure that there are adequate arrangements for buy-in of securities where there is a failure to settle a transaction within four business days after the day on which settlement is due; and (iv) creates new powers for national regulators and for ESMA.

As this measure is enacted through an EU regulation, it is directly applicable in all EU Member States and no national measures are required to implement its requirements. This means that, for the first time, the rules relating to short selling are harmonized across the EU and the divergent rules in relation to short selling which were applied by individual EU Member States have been superseded.

The EU Short Selling Regulation is supplemented by a European delegated regulation as well as regulatory and implementing technical standards (collectively referred to as the "Level 2 Regulations") comprised of the following:-

(i) Commission Delegated Regulation (EU) No 826/2012 of 29 June, 2012 supplementing the EU Short Selling Regulation with regard to regulatory technical standards on notification and disclosure requirements with regard to net short positions, the details of the information to be provided to ESMA in relation to net short positions and the method for calculating turnover to determine exempted shares ("RTS 1 Regulation");

(ii) Commission implementing Regulation (EU) No 827/2012 of 29 June, 2012 laying down implementing technical standards with regard to the means for public disclosure of net position in shares, the format of the information to be provided to ESMA in relation to net short positions, the types of agreements, arrangements and measures to adequately ensure that shares or sovereign debt instruments are available for settlement and the dates and

[1] The term EU should be understood to mean all member states of the European Union plus Norway, Iceland and Liechtenstein.

period for the determination of the principal venue for a share according to the EU Short Selling Regulation (the “ITS Regulation”);

(iii) Commission Delegated Regulation (EU) No 918/2012 of 5 July, 2012 supplementing the EU Short Selling Regulation with regard to definitions, the calculation of net short positions, covered sovereign credit default swaps, notification thresholds, liquidity thresholds for suspending restrictions, significant falls in the value of financial instruments and adverse events (the “Delegated Acts Regulation”); and

(iv) Commission Delegated Regulation (EU) No 919/2012 of 5 July, 2012 supplementing the EU Short Selling Regulation with regard to regulatory technical standards for the method of calculation of the fall in value for liquid shares and other financial instruments (the “RTS 2 Regulation”).

In addition to the above, ESMA has adopted a Q&A which will be updated and expanded on from time to time, the purpose of which is to promote common supervisory approaches and practices in the application of the European short selling regulatory regime. It provides responses to questions posed by the general public, market participants and competent authorities in relation to the practical application of the short selling framework.

The ESMA Q&A document can be viewed here: [http://www.esma.europa.eu/system/files/2012-572.pdf](http://www.esma.europa.eu/system/files/2012-572.pdf)

## Packaged Retail Investment Products

On 3 July, 2012 the Commission proposed a legislative package which it hopes will help rebuild investor confidence in retail investment products. The proposed regulation will require all investment funds, structured products and some insurance products to put a key information document ("KID") in place.

The package contains three arms:

- a proposed revision of the Insurance Mediation Directive;
- a proposed amendment to the UCITS Directive; and
- the proposed introduction of a regulation on KIDs for packaged retail investment products ("PRIPs").

For the investment funds industry this will be relevant particularly for non-UCITS funds which are sold to retail investors. The proposed regulation, when implemented, will require non-UCITS retail funds to produce a short form KID (generally two pages) in a standardised format, summarising the main terms of the product and to provide the KID document to prospective investors generally before a contract is concluded.

At this stage it is envisaged that the proposal will become effective at the end of 2014.

The European Fund and Asset Management Association ("EFAMA") have responded in a positive manner to the Commission's proposal. The UCITS KIID has been particularly praised by EFAMA. EFAMA have expressed a view that the UCITS KIID should be the benchmark for the KID. EFAMA have also noted that PRIPs cover a very wide range of products designed for different purposes and that consequently there needs to be flexibility in the content of the KID.

Key comments EFAMA have made in relation to the Commission's proposal include the following:

- Scope of the KID

EFAMA supports private pension products being included in the PRIPs proposal and it also supports the exemption which is available for pensions that are subject to the Institutions for Occupational Retirement Provision ("IORP") Directive.

- Nationally-regulated, open-ended, non-UCITS retail funds

EFAMA strongly recommend that non-UCITS retail funds ought to be allowed to choose to produce a KID in line with the UCITS KIID rather than a PRIP KID. EFAMA also recommends that there should be national discretion in each Member State which would allow non-UCITS funds to use a KID that is in line with the UCITS Directive instead of the PRIP KID.

- Content of the KID

EFAMA has expressed concern with certain aspects of the KID content. For example the heading *'Could I lose my money?'* could possibly mislead investors. EFAMA has also called for an expansion of the section which deals with costs.

- Legal status of the KID

EFAMA are of the opinion that the pre-contractual nature of the KID should be clarified in order to ensure a level playing field across all investment products.

- Consequential amendments required for the UCITS KIID

EFAMA welcomes the exemption of UCITS from KID regulation.

EFAMA's comments may be found here:
http://www.efama.org/Publications/Public/PRIPS/12-4041_EFAMA%20Comments%20on%20the%20EC%20Proposal%20for%20a%20Regulation%20on%20key%20information%20documents%20for%20investment%20products.pdf

## Irish Taxation Update for Funds

The 2013 Irish Budget (hereafter referred to as "**Budget 2013**") was announced on 6 December 2012 and included therein are several measures that are specifically relevant to the Irish fund industry.

**(i) FATCA – Conclusion of Irish / US Intergovernmental Agreement**

A welcomed announcement within the Budget 2013 speech was the confirmation that that the Irish and US Governments have concluded an intergovernmental agreement ("Irish IGA") in relation to the US Foreign Account Tax Compliance Act – commonly referred to as FATCA.

Mr Michael Noonan T.D, Minister for Finance and Chargé d'affaires at the U.S. Embassy in Ireland, John Hennessey-Niland signed in Dublin the Irish IGA on 21 December 2012. Ireland is now one of only four countries to have signed an IGA with the United States.

This agreement will be of benefit to Ireland as it is intended to reduce and simplify the administrative and compliance burdens for relevant Foreign Financial Institutions or "FFI's" (which is broadly defined under FATCA and would include Irish funds) and therefore may provide a competitive advantage as compared to other countries which may not be able to reach a similar agreement with the US. Under the Irish IGA, relevant FFI's will report directly to the Irish Revenue Commissioners and will therefore not be required to enter directly into potentially onerous FFI Agreements with the US Internal Revenue Service (which would generally be required in the absence of an IGA).

Under the Irish IGA, a relevant FFI will also typically not be required to apply the 30% withholding tax that FATCA could generally impose.

The relevant Irish legislation to implement the Irish IGA will need to follow a number of steps. The Irish IGA will first need to be transposed into Irish law by means of a Statutory Instrument. The enabling legislation will then need to be introduced into the Taxes Consolidation Act 1997. It is hoped that can be done by its inclusion in the Finance Act 2013 (which is expected to be passed in March 2013 - the Finance Bill 2013 is expected to be published in January 2013). If that is not possible, then the necessary legislation to include the Irish IGA in the Taxes Consolidation Act 1997 will need to be introduced by means of another Act.

HM Revenue & Customs has issued a set of frequently asked questions on data protection issues related to the implementation of the equivalent U.K./U.S. agreement. While these FAQs naturally reflect U.K. data protection legislation, there is a significant degree of overlap between that and Irish data protection legislation (both stemming from Directive 95/46/EC) and therefore the FAQs may be seen as a rough guide for the purposes of Irish-domiciled funds.

The HM Revenue & Customs FAQs may be viewed at the following link: http://www.hmrc.gov.uk/budget-updates/march2012/draft-dpa-fatca-faqs.pdf

**(ii) Introduction of the Real Estate Investment Trust (REIT)**

Budget 2013 has confirmed the introduction of an Irish Real Estate Investment Trusts ("**REIT**"). Real Estate Investment Trusts are established as listed companies and are used to invest in a diverse range of rental investment properties in a tax efficient manner. They are already a very well established and utilised vehicle in Europe, the US, Asia and Australia and it is hoped that the introduction of the REIT will do much to stimulate growth in the Irish property market by encouraging foreign investment and indeed complementing the Irish Funds industry.

Although there is little detail available it has been confirmed that a REIT will be exempt from corporation tax on qualifying income and gains. However, the REIT will be required to distribute the large majority of its profits annually to its' respective investors and these distributions will be taxed at the level of the investor. It is likely that these distributions will be subject to a customised tax regime; however, this will become clearer once the Finance Bill is issued in early 2013.

Investors will benefit from the use of the REIT as it avoids the potential double taxation issues that arise when investing in property through a normal property investment company and also reduces investment risk as the REIT invests in a wide variety of rental properties and thus risk is diversified. The REIT is also a very liquid scheme for prospective investors as it allows for the investors to sell their shares at any time.

The introduction of the REIT is yet another measure to attract new investment in property transactions, and follows on from the reduction last year of stamp duty from 6% to 2% for commercial property transactions which has helped to bring stability to the commercial property sector.

**(iii) Investment Funds – Increase in applicable rates for "chargeable events" for certain Irish Investors**

While Irish regulated investment funds are exempt from tax arising on their income and gains, Irish tax legislation allows for tax to be applied on certain "chargeable events" for certain Irish investors (not falling within the exempt Irish investor category).

Budget 2013 proposes to increase rates of tax applicable on these “chargeable events” from 30% to 33% for payments made annually or more frequently and from 33% to 36% for payments made less frequently than annually. As always, this tax is **not** applicable to non-Irish resident investors (in so long as the non-resident investors in question have made a relevant declaration or the investment undertaking has satisfied and availed of the “Equivalent Measures” regime).

**(iv) VAT and Stamp Duty**

Budget 2013 did not announce any changes to Stamp Duty or to the current rates of VAT.

## Data Protection

**(i) Data Protection Regulation**

On 25 January, 2012 the European Commission outlined its proposals for a fundamental overhaul of data protection rules in the European Union.

The European Parliament's Committee on Employment and Social Affairs published its draft opinion on the revised General Data Protection Regulation on 8 November, 2012. The Committee's draft opinion focuses on employee data issues. In particular, the draft opinion raises a concern with attempts to regulate the privacy of employee data in one article and notes that the Regulation only provides a minimum level of protection for employees.

## Anti-Money Laundering/Counter-Terrorism Financing

**(i) Criminal Justice (Money Laundering and Terrorist Financing) (Amendment) Bill 2012**

The Department of Justice has published the draft heads of a new Bill in the area of anti money laundering ("AML") - the Criminal Justice (Money Laundering and Terrorist Financing) (Amendment) Bill 2012 (the "Bill"). The Bill is seeking to clarify certain aspects of the Criminal Justice (Money Laundering and Terrorist Financing) Act 2010 (the "Act"), following concerns raised by the Department of Justice as well as matters raised by the Central Bank. The accompanying press release to the Bill states that the Government intends to make further amendments to the Bill at a later date as it considers its response to the Mahon Tribunal and representations from IFSC firms who use the services of parties outside the State for customer identification purposes. It is expected that the Bill be published during 2013.

The amendments proposed in the Bill include;

- Lowering the identification threshold for private members gaming clubs from €15,000 to €2,000;

- Section 31 of the Act (which permits the Minister for Justice, Equality and Law Reform (the "Minister") to designate certain countries outside the EU as having equivalent standards to those specified in the Third AML Directive) will be amended such that a designated person must carry out its own risk assessment on such specified countries if the designated person wishes to rely on a relevant third party in such countries or apply simplified due diligence to specified customers from such countries. Unfortunately the Bill is silent as to what measures a designated person can take in relation to third parties in those Non-EU countries which are not on the list of specified countries (i.e. those countries which are not on the good list of countries under Section 31 or the bad list of countries under Section 32);

- Section 34 of the Act, which deals with specified customers and specified products – i.e. the situations where simplified due diligence can be applied – is proposed to be amended whereby the designated person can apply simplified due diligence to such customers/products where the designated person has taken steps to determine whether or not the customer or product is a specified customer or product;

- Section 54 of the Act will be amended to specifically include the keeping up to date of documents obtained for due diligence purposes and the future-proofing of procedures to accommodate new technological developments; and

- Section 55 of the Act is to be amended such that records will no longer have to be kept in the State.

**(ii) Central Bank issue letter with regard to the Criminal Justice (Money Laundering and Terrorist Financing) Act 2010 (the "Act")**

On 12 October, 2012, the Central Bank issued a letter to all Irish-regulated credit and financial institutions on foot of a number of inspections conducted across all regulated sectors. The letter sets out an overview of control deficiencies the Central Bank has recognised and actions the Central Bank expects firms to take to identify similar deficiencies in their anti-money laundering and counter-terrorism financing frameworks.

The letter detailed the following control failures;

*Governance*

Board/Senior Management were unable to demonstrate that they;

- had considered the implications of the Act for their business;
- had allocated the necessary resources to implement the changes required as a result of the enactment of the Act;
- had an appropriate governance framework to ensure ongoing oversight of compliance by the firm with the Act; and
- understood the potentially serious implications for the firm and for individual staff members/directors where the firm failed to comply with the Act.

*Risk Management*

Firms were not able to demonstrate that they had;

- evaluated the risks of anti-money laundering and terrorist financing pertinent to their business sector;
- adopted appropriate risk mitigation plans to mitigate risks; and
- evaluated specific risks for their business activities or were unable to produce detailed rationale for risk mitigation plans adopted.

*Policies and Procedures*

The Central Bank felt that firm's anti-money laundering and counter terrorist financing policies were deficient in the following ways;

- There was material gaps in the anti-money laundering and counter terrorist financing policies and procedures adopted by firms to prevent and detect money laundering and terrorist financing;
- Anti-money laundering and counter terrorist financing procedures must cover all areas of the business.

The Central Bank expects ongoing senior management oversight as to the appropriateness and effectiveness of such anti-money laundering and counter terrorist financing procedures.

*Training*

The Central Bank stated that firms could not adequately demonstrate that directors/employees had received adequate training in the area of anti-money laundering and counter-terrorist financing.

*Customer Due Diligence ("CDD")*

The Central Bank stated that CDD remediation work for existing customers was not being carried out in a systematic or comprehensive manner. They also stated that the verification of customers was not being completed as soon as practicable and that firms were not documenting the point at which they would terminate the customer relationship if a customer continues to fail to provide CDD documentation.

*Suspicious Transaction Reporting ("STR")*

The Central Bank felt that firms were not filing STRs as soon as practicable, which is the standard required by the Act.

A copy of the letter may be viewed here:
http://www.centralbank.ie/regulation/processes/enforcement/Documents/Dear%20CEO%20AML-CTF%20letter.pdf

**(iii) Fourth Anti-Money Laundering Directive**

The Commission plans to publish a legislative proposal for a Fourth Anti-Money Laundering Directive in early 2013. Prompted by the new international Financial Action Task Force ("FATF") recommendations published in February 2012, the Fourth Anti-Money Laundering Directive will most likely address the following issues;

- broadening the risk based approach to incorporate more risk based elements so that resources can be focused where they are most needed;
- possible clarification of the CDD rules so that it is clear that the simplified procedures are not wrongly perceived as full exemptions from CDD;

- incorporating new provisions to deal with Politically Exposed Persons ("PEPs") at domestic level;
- clarification as to how AML supervisory powers will apply in cross border situations;
- strengthening the powers and co-operation between the different Financial Intelligence Units within the EU; and
- incorporating new provisions on data protection to deal with the Commission's proposals on data protection reform as published in January 2012.

Ugo Bassi, Head of Unit at DG Internal Market and Services at the Commission has said that the proposal for the fourth Anti-Money Laundering Directive "should be ready in early 2013 and would hopefully be adopted by the two co-legislators by the end of 2013".

## Central Bank

**(i) The Central Bank Strategic Plan 2013-2015**

The Central Bank published its Strategic Plan 2013-2015 in November, 2012. A list of planned reviews/inspections will be published in early 2013.

The main objectives of the Strategic Plan are as follows;

(1) To restore financial stability and support economic recovery through a successful exit from the EU-IMF Programme of Financial Support and restoring a fully functioning banking system;

(2) Reform of the regulatory and supervisory framework to ensure risks to stability and consumer protection are identified and effectively mitigated;

(3) Protection of consumers by challenging firms' compliance, promoting a better culture in the financial sector and helping consumers have more confidence in financial services; and

(4) Influencing the increasingly international policy-making framework for monetary policy, financial stability and regulatory standard setting.

The key focus shall be on "improved operational efficiency and cost effectiveness".

The Strategic Plan is available to view on the Central Bank's website;
http://www.centralbank.ie/publications/Documents/Central%20Bank%20of%20Ireland%20Strategic%20Plan%202013%20-%202015.pdf

**(ii) Probability Risk and Impact System ("PRISM")**

The Central Bank launched its risk-based supervision framework, PRISM on 1 December, 2011. The Central Bank has recently started to engage with regulated firms under the framework whereby regulated firms have been requested to attend a meeting with the Central Bank.

Under PRISM, the Central Bank aims to supervise regulated firms in a manner that will make it less likely that they will fail in a way that would damage financial stability or endanger consumers. The Central Bank aims to further improve its culture of regulation and to ensure a consistent approach to supervision of firms.

PRISM has the effect of making it easier for the Central Bank's supervisors to judge risks, challenge firms they regulate and take action to mitigate those risks. The main focus is on preventing these larger regulated firms from failing in a disorderly fashion. Regulated firms which are low risk shall be supervised reactively or through systemic assessments. PRISM is designed to use the Central Bank's supervisors in an effective and cost-effective manner. It is expected that PRISM will make a significant contribution to the Central Bank's efforts to help the economy recover.

On 11 October, 2012 Ms. Fiona Muldoon (Director, Credit Institutions & Insurance Supervision) of the Central Bank delivered a presentation entitled "Enterprise Risk Management in Insurance Undertakings". This presentation looked at the impact of firms by sector under PRISM as of September 2012. Of the 177 Non-UCITS and SMICs, 14 were deemed to be medium-low risk and 163 low risk. All 4935 funds were deemed to be low risk.

**(iii) CP61**

The Central Bank published a Consultation Paper 61 on 20 November, 2012 on proposed changes to the basis for calculating the industry funding levy payable by regulated entities. The most notable change is to more closely align the funding levies paid by regulated entities with the costs of their supervision. This is logical because the impact categorisation of regulated entities, as determined by PRISM, determines the number of supervisors assigned to that firm.

The Central Bank also proposes introducing application fees for firms seeking authorisation to provide financial services. These application fees will reflect the average cost involved in processing applications.

The consultation runs until 22 February 2013. The paper may be viewed here: http://www.centralbank.ie/regulation/poldocs/consultation-papers/Documents/CP61%20Consultation%20on%20Impact%20Based%20Levies%20and%20Other%20Levy%20Related%20Matters/2012%20Impact%20Based%20Levy%20Consultation%20Paper%20CP61.pdf

**(iv) Online Reporting System**

The Central Bank has issued letters to Irish domiciled funds and management companies which relate to a new web based/online filing process which the Central Bank is introducing at the end of Q1 2013 for all funds/management companies.

To date, most regulatory filings which Irish authorised funds are obliged to make with the Central Bank have been filed in hard copy or by email by either the fund administrator or fund lawyers. In 2011, the Central Bank introduced a web based/online system for filing Director's Individual Questionnaires and it is now extending that new Online Reporting System (ONOR System) through which many reports will have to be filed. The Central Bank considers that once the ONOR System is in operation, it should be a more efficient procedure for both the Central Bank and the regulated funds/management companies.

The online filing process requires a System Administrator to be nominated to oversee the various electronic filings to be made under the new process. The Central Bank imposed a deadline of 17 December, 2012 for the nomination of a system administrator.

**(v) Central Bank holds Enforcement conference**

The Central Bank held its first Enforcement conference (the "Conference") on 11 December, 2012. The Deputy Governor of the Central Bank, Matthew Elderfield, strongly defended the imposition of public sanctions on firms that breach banking rules and urged more action on financial white collar crime. Those in attendance at the Conference were told that in the last three years, the Central Bank has concluded 30 administrative sanctions cases and imposed approximately €13.3 million in fines.

While it was acknowledged that the current sanction regime has made firms in the industry uncomfortable, Mr. Elderfield noted that enforcement is usual practice in Britain, the US and across the European Union, for example in France, Germany, Sweden, Malta and Luxembourg.

Enforcement actions may be taken for a number of reasons and there are various outcomes of enforcement actions including;

- to hold persons accountable for wrongdoing;
- to deter others from behaving in a similar fashion;
- to protect stakeholders (including consumers, investors and of course the public);
- to educate and signal the intention of regulators;
- to improve behaviours;
- to improve the current state/level of compliance;
- to improve the standards we expect of regulated persons;
- allow for more efficient and effective supervision (i.e. help with the deployment of scarce supervisory resources to areas where the return on policy initiatives is greatest, e.g. *PRISM*);
- to improve reputation (of Ireland, firms and industries);
- to compensate harmed investors; and
- to restore the special trust consumers, investors and the public place in firms and markets.

Enforcement action may be used in all sections of the regulated market and many different firms have been pursued to date such as banks, insurers, re-insurers, firms operating in the international financial services sector, retail intermediaries, stockbrokers and specialist MiFID firms among others.

Matters investigated to date include complaints handling, payment protection insurance, transaction reporting, prudential requirements, securities lending, client assets, AML/CFT, systems and control and specific retail intermediaries.

All administrative sanctions to date have been resolved by settlement, which includes the disqualifications of nine individuals.

The Central Bank's role as competent authority for the purposes of both the Third Anti-Money Laundering Directive and international obligations extending from FATF was addressed at the Conference. It was noted where there are concerns about a firm's compliance with the Act, referrals from the AML/CTF supervisory team can be made to the enforcement activity teams for enforcement investigation.

The Central Bank will shortly have a broader range of supervisory and enforcement tools to implement desired outcomes which will strengthen the Central Bank's powers to safeguard stability, to effectively regulate markets and financial firms and to protect consumers. An example of a development on the horizon is the Central Bank (Supervision and Enforcement) Bill 2011 which will have the effect of doubling the current administrative sanction penalties taking the maximum fine for individuals from €500,000 to €1 million and for corporate bodies from € 1 million to €10 million (or 10% of previous year turnover) respectively.

The presentation delivered at the conference may be viewed here; http://www.centralbank.ie/regulation/processes/enforcement/Documents/Enforcement%20Conference%20Presentations%20(for%20circulation).pdf

## Companies Bill 2012

The Minister for Jobs, Enterprise and Innovation Richard Bruton (the "Minister") published the Companies Bill 2012 (the "Bill") on 21 December 2012. The Bill aims to reduce the costs associated with incorporating companies in Ireland, to reduce certain administrative red tape with which companies in Ireland must currently comply with and proposes to make company law obligation easier to understand. The Bill proposes to consolidate the existing 16 Companies Acts, which date from 1963 to 2012, into a single Act.

The Bill also proposes wide-ranging reforms which include the following;

- the codification of directors' duties;
- permitting a private company limited by shares to be formed with one director;
- removing the obligation for companies to have an objects clause;
- permitting companies to have a one-document constitution;
- "summary approval procedures" which will allow companies to carry out certain activities by means of a directors' declaration and a shareholders' resolution for those activities which under the current law would require High Court approval (for example, certain transactions with directors, capital reductions, and solvent windings up);
- new procedures regarding mergers and divisions; and
- proposals to extend the audit exemption.

While the Government has indicated that it will prioritise the progress of this Bill through the Oireachtas, it is unlikely to be enacted before the end of 2013 due to its size and the fact that it is a reforming Bill.

**Dillon Eustace**

**This Funds Quarterly Legal and Regulatory Update is for information purposes only and does not constitute, or purport to represent, legal advice. It has been prepared in respect of the current quarter and, accordingly, may not reflect changes that have occurred subsequent to the start of such period. If you have any queries or would like further information regarding any of the above matters, please refer to your usual contact in Dillon Eustace.**

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