October 2015

New Central Bank UCITS Regulations

On October 5, 2015 the Central Bank of Ireland (the "**Central Bank**") issued a new set of regulations relating to Irish domiciled UCITS, their management companies and their depositaries titled *Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) (Undertakings for Collective Investment in Transferable Securities) Regulations 2015* (the "**CBI UCITS Regulations**"). The CBI UCITS Regulations will replace the UCITS Notices from November 1, 2015.

The Central Bank UCITS Guidance Notes are also being replaced with website guidance which "*will retain all of the guidance currently located in the Guidance Notes and UCITS Notices*". That website guidance is now accessible on the Central Bank's website.

Simultaneously, the Central Bank has issued an updated UCITS Q&A document (7th Edition) and has published its Feedback Statements to 2014's CP77 (*Consultation on publication of UCITS Rulebook*) and CP84 (*Consultation on the adoption of ESMA's revised guidelines on ETFs and other UCITS issues*).

In its Feedback Statement on CP77, the Central Bank says "*As stated in CP77, the Central Bank is issuing the final UCITS Rulebook on a statutory basis. Having considered the options available to the Central Bank to achieve this, the Central Bank has decided to publish the final UCITS Rulebook in the form of Central Bank regulations*".

For further information on any of the issues discussed in this article please contact:

Andrew Bates
DD:+ 353 (0)1 673 1704
andrew.bates@dilloneustace.ie

CBI UCITS Regulations

The CBI UCITS Regulations are issued by the Central Bank pursuant to powers given to it under Section 48(1) of the Central Bank (Supervision and Enforcement) Act, 2013 (the "**2013 Act**") which section provides that the Central Bank may make regulations for the proper and effective regulation of regulated financial service providers.

The CBI UCITS Regulations are arranged in 13 Parts which are:

Part 1: Preliminary and General
Part 2: Restrictions on UCITS
 Chapter 1: General Restrictions
 Chapter 2: Investment Restrictions
 Chapter 3: Financial Derivative Instruments
 Chapter 4: Efficient Portfolio Management
 Chapter 5: Share Classes
 Chapter 6: Constitutional Documents
 Chapter 7: Dealing
 Chapter 8: Valuation
 Chapter 9: Remuneration
 Chapter 10: Transactions Involving Connected Persons
 Chapter 11: Directed Brokerage Services
Part 3: Supervisory Requirements
Part 4: Prospectus Requirements
Part 5: Key Investor Information Document
Part 6: General Operational Requirements
Part 7: Annual and Half-Yearly Reports of a UCITS
Part 8: Requirements in respect of Specific Types of UCITS
Part 9: Guaranteed UCITS
Part 10: Cross-border Notification of UCITS
Part 11: Management Companies
 Chapter 1: General Requirements
 Chapter 2: Management Company Passport
Part 12: UCITS Depositaries
Part 13: Miscellaneous Provisions

The 11 Schedules to the CBI UCITS Regulations cover:

Schedule 1: Regulatory Criteria
Schedule 2: Netting and Hedging
Schedule 3: Conditions for Collateral received by UCITS
Schedule 4: Calculation of Global Exposure using the Value at Risk approach
Schedule 5: Methods of Valuation

Schedule 6: Advertising Standards for certain UCITS
Schedule 7: Additional Information to be included in the Annual Report
Schedule 8: Additional Information to be included in the Half-Yearly Report
Schedule 9: Minimum Capital Requirement Report
Schedule 10: Managerial Functions of the Management Company
Schedule 11: Records of the Management Company

Does this all sound a bit familiar?

At one level, the CBI UCITS Regulations are simply the result of a process of bringing together, in one place, those conditions or requirements which the Central Bank previously imposed via the UCITS Notices, but stripping out all elements of repetition of provisions of the UCITS Regulations and also what might be considered to constitute guidance.

Although presented as exactly that – "*a UCITS Rulebook which consolidates into one document all of the conditions which the Central Bank imposes on UCITS, their management companies and depositaries*" - these CBI UCITS Regulations seem to be something more than that, perhaps more focused on enforcement than regulation.

What was wrong with the UCITS Notices?

UCITS, their management companies and their depositaries were already subject to the conditions and requirements which the Central Bank, pursuant to Regulation 123 of the UCITS Regulations, issued via the UCITS Notices "*for the purposes of the orderly and proper regulation of UCITS….*".

In issuing the new CBI UCITS Regulations the Central Bank is not trying to – it cannot - alter the UCITS Directive or the European Communities (Undertaking for Collective Investment in Transferable Securities) Regulations 2011 (the "**UCITS Regulations**") which implement the UCITS Directive into domestic Irish law. It also does not seem to be adding to the UCITS requirements which, for the last 25 years, it has applied via a set of UCITS Notices which, in essence, put meat on the bone of the UCITS Regulations and evolved to take account of developments such as the Eligible Assets Directive, various ESMA Guidelines and domestic Central Bank rule making around the operation of UCITS management companies, depositaries and fund administrators.

The Central Bank is not seeking to change the investment restrictions for UCITS. It is not seeking to change the method of calculating global exposure generated through the use of financial derivative instruments. It is not changing rules regarding the constitutional documents of Irish UCITS nor is it adding to the prospectus requirements. It does not really seem to be adding any new substantive regulatory requirements at all.

It seems that the only rationale for these CBI UCITS Regulations is to be able to demonstrate that a breach of the CBI UCITS Regulations constitutes a "*prescribed contravention*" for the purposes of its enforcement/sanctions regime under Part IIIC of the Central Bank Act, 1942.

If that is the Central Bank's position, it will presumably want to also withdraw the AIF Rulebook and replace it with a set of CBI AIF Regulations.

The "responsible person"

These CBI UCITS Regulations will be of particular interest to those who fall within the definition of "*responsible person*" as that is the person upon whom most of the requirements are imposed. The Regulations throughout impose on such persons either obligations (*i.e. shall ensure; shall obtain; shall use etc.*) or prohibitions (*i.e. shall not invest*). The term "*responsible person*" means a management company, where one has been designated to act in respect of a particular UCITS and in the absence of any such designation, the UCITS itself.

The term "*management company*" is defined as "*has the meaning given to the term in the UCITS Regulations, with the exception of Part 11 where the term refers exclusively to a management company for which the Bank is the management company's home Member State*". Part 11 deals with operating conditions, organisational requirements, record keeping etc. of management companies. It would appear, however, that in all other provisions the Central Bank UCITS Regulations could apply to a non-Irish UCITS management company which is managing an Irish domiciled UCITS. That is an interesting development which we will need to consider further in light of UCITS Directive provisions and cross-border rules.

"…….shall ensure"

Throughout the CBI UCITS Regulations obligations are imposed on the "*responsible person*" using the term "*shall ensure that*….". The concern that we have regarding the use of "*shall ensure*…." is that it is a high hurdle to clear, perhaps one that is too high or that might prove too rigid when applied.

For example, in Chapter 8 of Part 2 dealing with Valuation, Regulation 34 provides that a responsible person shall establish and "*ensure adherence*" to a valuation policy that satisfies a number of set requirements. Given that the application of the policy will generally be given to a fund administrator and given that pricing errors can arise (which may involve a failure to apply the valuation policy properly), it does not seem reasonable to require a responsible person to "*ensure adherence*" to the valuation policy.

Another example is Regulation 37 which provides that a responsible person "*shall ensure that securities prices*" and currency rates used by UCITS for valuation purposes "*are up-to-date*" and are provided by and obtained from a source that the responsible person considers to be reputable and reliable……. What might the position be where a third party price vendor's systems malfunction and it provides the UCITS with a securities price that is not up-to-date? Would the UCITS management company have failed to comply with Regulation 37 as it did not ensure that the securities price was up-to-date? Might it be subject to enforcement?

That "*shall ensure*" this is the terminology that is being used throughout is of some concern, if it proves to be the case that these Regulations have been introduced principally for enforcement purposes.

Half-Yearly Management Accounts

The CBI UCITS Regulations require a UCITS management company to produce not only a set of half-yearly unaudited financials for the first 6 months of the year but also, <u>in addition</u> to the audited financials for the entire 12 month period, a set of half-yearly unaudited financials for the second 6 months of the year. Respondents to CP77 were opposed to this on several grounds (time, cost etc.) but the Central Bank has maintained its position.

Interest Rate Hedged Classes

The Central Bank has, to date, allowed interest rate hedged classes, in similar fashion to hedged currency share classes, and has confirmed that in written guidance. There is nothing in the UCITS Directive or UCITS Regulations to prohibit the use of interest rate hedged classes although we note that ESMA has not yet pronounced on the issue. Some of our clients do use them and it is of some concern to them that, whilst there is a general provision for share classes in the CBI UCITS Regulations, there is a specific reference to hedged currency share classes but not to interest rate hedged classes. Our understanding is that the Central Bank will continue to allow interest rate hedged classes (unless ESMA indicates they should not be permitted for UCITS funds). It would perhaps have been better to have either referred to both (or to neither).

Priority when a "gate" applied

Another interesting point coming from the CP77 feedback is that the Central Bank now requires that where a UCITS applies a redemption gate, unsatisfied redemption requests should not receive priority. Therefore on the dealing day following the application of the gate, all redemption requests will be dealt with on a *pro rata* basis should the gate continue to apply.

The Central Bank feels that applying priority to redemption requests which have been subject to a gate may materially prejudice investors, particularly small investors. This may not be consistent with what managers feel to be fair, and may not reflect the provisions of UCITS constitutional documentation. It is also not entirely clear what action UCITS must now take to address this new position.

Derogations

Industry participants will be familiar with the concept of applying for and obtaining derogations from the Central Bank UCITS Notices. We do not yet know what the status of those derogations will be under the new regulatory framework. This needs to be clarified.

Promoter requirement now gone

The promoter regime for UCITS is now gone. The Central Bank is not introducing new obligations on UCITS management companies as a result, but has elaborated on the obligations of directors when a UCITS gets into difficulties.

Timing and Transition

The CBI UCITS Regulations will come into force on November 1, 2015.

We do not know whether the Central Bank will expect UCITS and UCITS management companies to update their business plans, policy documentation and other relevant documentation immediately or whether they can do it over time, or whether they should do it when the outcome of CP86 is complete (delegation/managerial functions) or whether they can wait until addressing UCITS V. It would be preferable to address simultaneously rather than having to deal with all these changes separately or sequentially.

Andrew Bates
Dillon Eustace
October 2015

DILLON EUSTACE

Dublin
33 Sir John Rogerson's Quay, Dublin 2, Ireland. Tel: +353 1 667 0022 Fax: +353 1 667 0042.

Cayman Islands
Landmark Square, West Bay Road, PO Box 775, Grand Cayman KY1-9006, Cayman Islands. Tel: +1 345 949 0022 Fax: +1 345 945 0042.

Hong Kong
604 6/F Printing House, 6 Duddell Street, Central, Hong Kong. Tel: +852 352 10352.

New York
245 Park Avenue, 39th Floor, New York, NY 10167, U.S.A. Tel: +1 212 792 4166 Fax: +1 212 792 4167.

Tokyo
12th Floor,Yurakucho Itocia Building, 2-7-1 Yurakucho, Chiyoda-ku, Tokyo 100-0006, Japan. Tel: +813 6860 4885 Fax: +813 6860 4501.