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COVID-19 Implications for Investment Funds and Fund Management Companies

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Fund management companies (“**FMCs**”) and the investment funds they manage have been presented with a number of challenges arising from the COVID-19 global pandemic. We have set out below some of the key challenges and important considerations for FMCs and investment funds as they navigate their way through

the current crisis. A key point to note is, where any issues potentially impacting a fund and its investors are identified, it is important to engage early with the Central Bank of Ireland (“**Central Bank**”) through the relevant supervisory team or usual Central Bank contact.

Business Continuity

The Central Bank’s expectations regarding business continuity are set out in its **Guidance for Fund Management Companies**.

On 11 March 2020, the European Securities and Markets Authority (“**ESMA**”) issued a **statement** in relation to COVID-19 which addressed business continuity planning (“**BCP**”) and stated that all financial market participants should be ready to apply their contingency plans, including deployment of business continuity measures, to ensure operational continuity in line with regulatory obligations.

In early March 2020, the Central Bank requested all FMCs to review their BCP arrangements and stated that any significant matters arising should be reported to the Central Bank.

In relation to the Central Bank’s own operations, the Central Bank confirmed to Irish Funds (the industry representative body) on 16 March 2020 that its BCPs are in place to ensure that it will continue to fulfil its public interest mandate.

Some points to note regarding business continuity:

- FMCs that rely on BCPs maintained by service providers should maintain frequent and close communication with those service providers on the maintenance of business continuity during the crisis and should seek confirmations from service providers that their BCPs are operating effectively.
- The crisis presents challenges for designated persons (“**DPs**”) in fulfilling their oversight role. DPs will have little or no ability to carry out onsite visits of delegates and other service providers and will therefore need to ensure that measures are in place to allow the role to be carried out remotely. All interactions and monitoring should be carefully documented in order to demonstrate compliance with DP obligations and there should be frequent reporting to boards during the crisis.
- Contingency planning should be in place for staff that may become ill (portfolio managers, board members or DPs).

Cybersecurity

In the current remote working environment, cybersecurity risks have increased. On 10 March 2020, the Central Bank published a letter outlining its recommendations and expectations regarding cybersecurity following its thematic review on this topic conducted last year. Firms should conduct a gap analysis of FMC's and service providers' cyber risk management against the Central Bank recommendations set out in the March 2020 letter.

Governance

It can be expected that, once we emerge from the current crisis, the Central Bank will conduct a review of how firms responded during the crisis and may take action against firms and individuals where they have failed to perform their role to the level expected by the Central Bank.

Board Meetings

The constitution of the fund / FMC will clarify the process relating to holding and participating in remote meetings.

Approvals may be required to be implemented by written resolution and in this regard the permissibility of e-signatures under Irish law will be relevant.

Tax advice should be sought in relation to the impact of travel restrictions with regard to maintaining the Irish tax residence of funds.

Committees of the board may need to be established to ensure that decision making can be effected in circumstances where it may be difficult to convene the full board.

The director responsible for organisational effectiveness (“**OE**”) is tasked with ensuring that the board and its delegates are operating effectively. The OE director should therefore critically review meeting agendas to ensure that important issues are prioritised in circumstances where meetings may be shorter than usual in light of the use of teleconferencing or video conferencing.

PCF Roles

The Central Bank's Fitness and Probity **Guidance** permits a person to perform a pre-approved controlled function (“**PCF**”) role without being approved in advance in very exceptional circumstances. The Central Bank's **Regulated Firms FAQ** on its **COVID-19 Hub** confirms that, if a PCF role holder is unable to perform their role due to illness or if a firm cannot fill a permanent PCF role vacancy due to COVID-19, the firm can seek to have another suitable individual perform that role for a limited period. This requires the prior agreement of the Central Bank. The Regulated Firms FAQ sets out the steps to be followed by a firm in these circumstances.

Regulatory Reporting

The Central Bank has made clear its view that reliable supervisory reporting is crucial in times when the financial system faces many challenges caused by the COVID-19 pandemic (see, for example, the Central Bank's **letter** to FMCs dated 30 April 2020 and the Central Bank's **Regulated Firms FAQ**). The Central Bank has **stated** that it will aim to be measured and pragmatic with its data requests in terms of the type and frequency of the requests. However, in recognition of the evolving nature of the pandemic, the Central Bank expects firms to continue to engage constructively with it and to respond to data requests in an expedient manner.

In late March 2020, the Central Bank wrote to FMCs requesting that they provide certain information about how the pandemic may be affecting their operations. The reporting frequency will depend on the PRISM rating of the FMC. (The Probability Risk and Impact System or PRISM is the Central Bank's risk-based framework for the supervision of regulated firms.) For most Irish FMCs, reporting is on a weekly basis. For those FMCs with a medium low or higher PRISM rating, reporting was originally required daily but has now moved to every Tuesday and Thursday for some of those FMCs.

Information required by the CBI:

- **Business continuity:** any update and / or significant developments on business continuity arrangements;
- **Delegates:** any issues with the oversight of delegates, including whether any alternative delegates are being considered;
- **Liquidity:** whether any liquidity management tools are being considered, such as the use of a redemption gate or the temporary suspension provisions;
- **Valuation:** any material issues relating to the pricing or valuation of securities; and
- **Cybersecurity:** any material issues to report in relation to emerging threats.

The DP for regulatory compliance should ensure that all requests for information from the Central Bank are responded to accurately, consistently and in a timely manner. The designated email address required to be maintained under the Central Bank's **Guidance for Fund Management Companies** should be monitored frequently by more than one individual to ensure all data requests are addressed expediently.

On 16 April 2020, the Central Bank **announced** a number of measures where regulatory flexibility will be allowed in respect of requirements applicable to securities markets, investment management and investment firms in light of the challenges posed by COVID-19. The measures, which are targeted at UCITS, alternative investment funds ("**AIFs**"), fund service providers, investment managers and investment firms, include flexibility on filing deadlines for a range of regulatory returns including annual and interim accounts and capital returns. Firms that can meet the existing reporting deadlines should do so.

At an EU level, on 31 March 2020, ESMA issued a **statement** that the first quarterly reports by money market fund managers under the EU Money Market Funds Regulation to be submitted to national competent authorities ("**NCAs**") are now postponed to September 2020. The Central Bank has **confirmed** that it will apply these measures.

Financial Statements

As noted above, on 16 April 2020, the Central Bank **announced** a number of measures where regulatory flexibility will be allowed in respect of requirements applicable to securities markets, investment management and investment firms in light of the challenges posed by COVID-19. The measures include flexibility on filing deadlines for the financial statements of authorised investment funds over the COVID-19 period. The Central Bank outlined its expectation that funds will file financial statements within the usual timeframes but stated that it will allow an extension provided that:

- the Central Bank and investors are informed as soon as practicable of the delay, the reasons for the delay and to the extent possible the estimated publication date; and
- the relevant regulatory return is submitted within the extended timeframe.

The extended timeframes are as follows:

- The deadline for filing annual audited financial statements for UCITS and AIFs with a year-end between 31 December 2019 and 1 April 2020 may be extended by two months.
- The deadline for filing annual audited financial statements for UCITS and AIFs with a year-end between 1 April 2020 and 1 May 2020 may be extended by one month.
- The deadline for filing semi-annual financial statements for a reporting period ending between 31 January 2020 and 1 April 2020 may be extended by one month.

ESMA has **advised** issuers to provide transparency on the actual and potential impacts of COVID-19, to the extent possible based on both a qualitative and quantitative assessment on their business activities, financial situation and economic performance in their 2019 year-end financial report, if these have not yet been finalised or otherwise disclosed in their interim financial reporting disclosures.

Liquidity

There had been an increased regulatory focus on fund liquidity issues prior to the crisis precipitated by the COVID-19 pandemic, with ESMA commencing a **common supervisory action** on UCITS liquidity risk management earlier this year, leading to the Central Bank issuing a liquidity questionnaire to UCITS management companies and self-managed UCITS to be completed by 25 March 2020. As part of its work on Brexit preparedness, in early January 2019, the Central Bank had also increased its monitoring of investment fund liquidity and redemption activity, including the increased frequency of data collection.

This recent increased focus on liquidity risk management and regulators' approval of a broad range of liquidity management tools ("LMTs") since the 2008 financial crisis may have mitigated some of the potential impacts of the current crisis. Though some funds have activated emergency LMTs to address the impact of the pandemic on the liquidity of underlying assets, few have been unable to fulfil redemption requests immediately or have been forced to implement a suspension of redemptions.

The availability of any LMTs will depend on the fund documentation. Boards should fully understand the process surrounding the use of LMTs, including the suspension and gating of redemptions. Any decision to utilise these tools may have to be taken within a very tight timeframe and therefore boards should have a clear understanding of the available LMTs and the legal, compliance and risk ramifications of implementing those tools. The best interests of both redeeming and remaining investors should be factored into the decision making process. Reputational risk will also be a key consideration.

Under the UCITS and AIFMD frameworks, FMCs are obliged to treat all investors fairly. Therefore, in dealing with redemption requests, FMCs may need to mitigate against any "first mover advantage" by "slicing their portfolio" to meet redemption requests ie, to sell assets pro-rata from the fund portfolio and not to sell liquid assets first to the disadvantage of remaining investors.

There must be frequent and open communication between the fund / FMC board, its senior management and DPs about how the fund is operating and potential impacts on investors. The fund / FMC board should receive regular updates on the changing liquidity profile of the fund during this time and should consider and approve any course of action proposed, clearly documenting the reasons for its decisions. Efforts should be made to ascertain the likelihood of significant redemptions. This may be more difficult for retail funds sold via distributors but non-retail funds should engage with institutional investors to assess the potential for significant redemptions.

Liquidity Management Tools

As noted above, the fund documentation should be consulted to establish what LMTs are available to the fund. In certain circumstances, prior engagement with the Central Bank will be required before implementing the LMT and a number of regulatory requirements may apply. The available LMTs may include:

- **Anti-Dilution Levies**

Where the fund documentation permits the application of an anti-dilution levy (“ADL”), the costs of realising assets to meet redemption requests are borne by the redeeming investors only, thereby protecting the investors who remain invested in the fund from any negative impacts that may result from significant redemptions. The application of an ADL may discourage investors from redeeming and seeking to benefit from a “first mover advantage”. However, some investors may view the application of an ADL as an indication that the fund’s liquidity profile is not aligned with their investment needs and they may reconsider their investment at a future date.

- **Redemption Fees**

Redemption fees may be applied to cover the costs associated with liquidating assets to meet redemption requests. Typically, a redemption fee will be a percentage of the net asset value of the shares being redeemed.

- **Swing Pricing**

Swing pricing is another anti-dilution technique that effectively passes on transaction costs to the redeeming shareholders to protect shareholders remaining in the fund from the impact of those transaction costs.

- **Redemption Gates**

Redemption gates may be used to slow down the rate of redemptions and to allow for the realisation of assets in an orderly and controlled manner. Depending on the type of fund, certain redemption thresholds may have to be met before a redemption gate can be imposed (eg, Irish UCITS or retail investor alternative investment funds (“RIAIFs”) may only gate redemptions once redemption requests received on any one dealing day amount to 10% or more of the net asset value of the relevant fund, or the total number of shares in the relevant fund).

- **Redemption in Specie**

It may be possible to redeem a holding of 5% or more in kind / in specie without shareholder approval in the current market. However, the potential impact on client relationships should be considered and it may be preferable, where possible, to obtain shareholder consent to implement an in kind / in specie redemption. The depositary must approve any in kind / in specie payments to ensure that a pro rata slice of the portfolio is paid out rather than the more liquid assets being distributed to the disadvantage of remaining investors.

- **Side Pockets**

Where the fund is an AIF, a side pocket share class may be created to separate illiquid assets from other more liquid investments. Once assets are transferred into a side pocket, only those investors in the fund at the time of the creation of the side pocket will be entitled to shares in the side pocket. While the remainder of an investor's shareholding can be redeemed in the normal manner as described in the fund's documentation, shares in the side pocket share class cannot be redeemed until such time as the underlying assets become sufficiently liquid. This avoids the need to redeem less liquid assets at heavily discounted prices in order to meet redemption requests. Certain confirmations must be provided by the AIF and its depositary to the Central Bank prior to side-pockets being established and all shareholders will also need to be informed.

- **Reduced Dealing Days**

Reducing dealing days may be considered in the short term to reduce issues arising on valuations and dealing.

- **Suspension of Redemptions**

Perceived as a draconian measure and very much a "last resort", some funds may need to consider a suspension of redemptions in the interests of investors in order to stop an potential "run" of redemptions and to avoid being compelled to accept heavily discounted valuations for portfolio assets. The Central Bank must be informed of any decision to suspend dealings on the day it occurs (and notification must also be made to any stock exchange for a listed fund) as well as any lifting of the suspension.

Central Bank Communications

The Central Bank issued an industry **letter** on liquidity management on 7 August 2019, where it stated that the "deployment of liquidity management tools such as duties & charges, gates and suspensions should be done in a transparent and proportionate manner, taking into account the best interests of investors". The Central Bank emphasised the importance of the liquidity risk management framework for each fund under management being calibrated to the dealing frequency, investment strategy, portfolio composition and investor profile of the fund on an ongoing basis. This point is reiterated in the **Regulated Firms FAQ**. The August 2019 letter noted that the responsibility for liquidity risk management, including compliance with all legislative and regulatory obligations, rests with the board of the FMC, the individual directors and the relevant DPs.

The Central Bank wrote to FMCs in late March 2020 requesting the provision of regular reporting (daily or weekly depending upon the PRISM rating of the FMC) in relation to whether any LMTs are being considered, such as the use of a redemption gate or the temporary suspension provisions.

The Central Bank also issued a **letter** to FMCs on 30 April 2020 in which it referred to its earlier August 2019 industry letter and noted that effective liquidity management includes an assessment as to whether a fund has appropriate LMTs in place. That assessment should take into account dealing frequency, investment strategy, portfolio composition and investor profile of the fund.

Valuation / Settlement

Boards need to be aware of any issues in providing valuations, any delays in the settlement of securities and any difficulties with net asset value (“NAV”) calculation. Fund valuation rules and the valuation policy may need to be reviewed for use of exceptional valuation measures to ensure the proper and accurate valuation of assets.

KIIDs

The synthetic risk and reward indicator (“SRRI”) in UCITS Key Investor Information Documents (“KIIDs”), which is essentially a volatility indicator, may need to be amended in light of market volatility during the crisis and any updated KIIDs must be filed with the Central Bank.

VaR

Funds / FMCs should consider the impact of market volatility on absolute or relative VaR calculation. There may be an elevated level of VAR back-testing exceptions.

The **Central Bank UCITS Regulations** provide:

“Where the results of the back-testing programme undertaken by virtue of this Regulation reveal a percentage of overshootings that exceeds 4 for the most recent 250 business days in the case of a 99 per cent confidence interval, the responsible person must review the VaR approach and make appropriate adjustments.”

UCITS Diversification Requirements and Investment Restrictions

In its **letter** dated 30 April 2020, the Central Bank acknowledges that, in light of recent market volatility, breaches of requirements set out in Central Bank UCITS Regulations or the AIF Rulebook may be identified. The Central Bank expects FMCs to minimise the potential for breaches, ensure that such breaches are reported to the Central Bank and remedied as a priority. FMCs should also consider whether such breaches need to be notified to investors.

Given the recent market volatility, continuing compliance with the 5/10/40 rule must be monitored. Where the limits 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 the remedying of that situation, taking due account of the interests of its unit-holders. While there is currently no Central Bank definition of what is meant by a passive or inadvertent breach, industry guidance classifies an inadvertent breach as a breach caused by factors outside the control of the FMC. A breach arising from a material error is required to be reported to the Central Bank promptly by the FMC and depositary. UCITS depositaries are required to report unresolved breaches arising from non-material errors within four weeks of the error. Pursuant to the guidance, material errors are those which have a NAV impact of $\geq 0.50\%$ ($\geq 0.10\%$ of NAV for MMFs). Errors may be deemed material if below the materiality threshold when account is taken of any relevant surrounding circumstances eg, the circumstances which resulted in the error or the duration of the error.

In the case of a passive / inadvertent breach, the Central Bank’s view is that redress should generally not be payable except where otherwise deemed appropriate by the depositary.

Short Selling

On 16 March 2020, ESMA issued a **statement** in respect of reporting of net short positions in shares traded on an EU regulated market. FMCs must consider any investments in scope of ESMA’s statement of 16 March 2020, requiring, with immediate effect, all holders of net short positions in shares traded on an EU regulated market (where that EU market is the principal trading venue for the shares) to notify the relevant NCA if the position reaches or exceeds 0.1% (the previous threshold was 0.2%) of the issued share capital of the issuing company. Funds / FMCs should also review any existing or proposed short positions within the scope of measures introduced by the French, Spanish, Italian, Belgian, Greek and Austrian regulatory authorities (and approved by ESMA under the EU Short Selling Regulation) to ban the creation of any new or further net short positions in shares admitted to trading on trading venues under their respective jurisdictions.

Amendments to Fund Documentation

In its **letter** to FMCs dated 30 April 2020, the Central Bank notes that, as part of their obligations to ensure risks are identified, monitored and managed during this time, FMCs may have identified a risk (or potential risk) which may warrant additional disclosure to investors (or potential investors). Where such risk is not already covered by existing prospectus disclosure and it may have a material effect on an investment made by an investor in a fund, a FMC should consider the extent to which the additional risk (or potential risk) should be brought to investors’ attention in the prospectus.

Human Resources

It must be remembered that the current crisis is fundamentally a human crisis and that the health and wellbeing of employees must be paramount. Firms should be mindful that not everyone’s experience of the crisis is identical and that individuals may have challenges other than those presented by the new remote working environment, such as where a close relative becomes ill. The importance of “down time” should be emphasised to ensure that personnel can sustain performance and ensure compliance with regulatory obligations.

Useful Links

- [☑ Central Bank of Ireland COVID-19 Hub](#)
- [☑ ESMA Covid-19 Page](#)

KEY CONTACTS

Full details of the Asset Management and Investment Funds Group, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team can be accessed at www.matheson.com.



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