Legal and Regulatory Update

The Irish Funds Industry Association responds to UCITS VI Consultation

The Irish Funds Industry Association ("IFIA") has made a detailed submission in response to the European Commission's consultation paper on UCITS titled “Product Rules, Liquidity Management, Depositary, Money Market Funds, Long Term Investments” (the “UCITS VI Consultation”), which was published in July 2012. (See our earlier briefing note for an outline of the issues raised in the UCITS VI Consultation.)

Partners Shay Lydon and Anne-Marie Bohan of the Asset Management Group at Matheson Ormsby Prentice were closely involved in developing the IFIA response. Shay Lydon co-chaired the IFIA UCITS Working Group which prepared the response and Anne-Marie Bohan was also an active member of the Working Group. On a pan-European industry level, Shay Lydon also contributed to the formal submission of the European Fund and Asset Management Association ("EFAMA") to the UCITS VI Consultation, which adopted positions consistent with the IFIA in addressing many of the questions raised by the Commission. Mr Lydon is the IFIA representative on the UCITS Standing Working Group established by EFAMA.

In responding to the Commission’s broad-ranging queries, the IFIA highlighted the success of UCITS III in introducing a level of flexibility in terms of eligible assets for UCITS, embraced by promoters and investors alike, which works within an investor-protection driven regulatory framework. This balance has been achieved through the robust control and risk monitoring systems applied by UCITS to monitor risk exposure (including market risk, counterparty risk and issuer concentration risk) and to maintain diversification and liquidity. The IFIA advocated that retail investors should continue to benefit from developments in investment management techniques and product innovation, subject always to the existing controls built into UCITS, and that there should be no retrenchment in respect of the product enhancements introduced through the UCITS III Directive.

A summary of the key points raised by the IFIA in relation to the eight topics dealt with in the UCITS VI Consultation is set out below.
Summary of the IFIA Response

1 Eligible assets for UCITS

The section of the UCITS VI Consultation on eligible assets commenced with a very broad query as to whether respondents believe that there is a need to review the scope of assets and exposures that are deemed eligible for UCITS before addressing specific queries in relation to market practice for UCITS, liquidity provisions, exposure to non-eligible assets, exotic derivatives, VaR usage, the use of the commitment approach as the sole measure of global exposure and a query as to whether the use of derivatives should be limited to instruments traded on multilateral platforms.

As noted above, the approach of the IFIA in responding to these queries was to highlight the success of the UCITS product in balancing investment flexibility with a comprehensive set of diversification requirements and robust control systems in respect of risk. The response noted the particular focus on diversification and liquidity and stated the IFIA’s belief that the focus for UCITS should continue to be on investor protection and risk management (including requirements in relation to back-testing, stress testing, regulatory reporting and disclosures to investors), rather than closing certain categories of asset class in their entirety to retail investors. In this regard, the IFIA noted the significant and ongoing work by the European Securities and Markets Authority (“ESMA”, previously CESR) to develop guidelines to strengthen investor protection and ensure greater harmonisation in regulatory practices, including in particular the publication of the ESMA Guidelines on ETFs and other UCITS issues in 2012 (ESMA 2012/474, the “ESMA 2012 Guidelines”) and the CESR Guidelines on risk measurement and counterparty exposure for UCITS in 2010 (CESR/10-788, the “ESMA Risk Measurement Guidelines”).

The IFIA confirmed that it would be very concerned about any proposal whereby a leverage test (whether the commitment approach or a “sum of the notionals” test) became the only method available to calculate global exposure. It noted that this point had been considered in detail by ESMA in the context of the ESMA Risk Measurement Guidelines and outlined industry concern that any narrow leverage test could provide a misleading assessment of a UCITS’ risk profile or volatility. By way of example, the IFIA noted that positions which economically offset risk, such as interest rate or currency hedges, would be required to be included in the commitment approach calculation, even though such transactions would ultimately reduce risk in a portfolio. As a result, a UCITS which employed such instruments and consequently had a global exposure over 200%, using the commitment approach, would ultimately be less risky for investors than a UCITS which did not hedge risk in this manner. The IFIA response noted that this point has been evidenced by the synthetic risk and reward indicators (“SRRI”) published by UCITS in the Key Investor Information Document.

The IFIA response agreed with the proposed focus on rules in relation to liquidity of assets and outlined criteria which industry in Ireland believes relevant in considering the manner in which exposure may be obtained to “non-eligible” assets through permitted investments in other collective investment schemes, transferable securities and derivatives in respect of financial indices. The IFIA also stated that UCITS should continue to be permitted to avail of bespoke OTC derivative arrangements, noting that the market in listed and traded derivative instruments is not sufficiently developed at this time to allow UCITS achieve their investment objectives through derivatives traded on exchange or multilateral platforms.
EPM and UCITS

The UCITS VI Consultation sought industry feedback on current market practice in respect of efficient portfolio management techniques, including types of transactions considered as EPM techniques, risk management policies in respect of EPM, duration of EPM transactions, collateral requirements and disclosure to investors.

The IFIA response confirmed that securities lending, repurchase and reverse repurchase agreements are typically used as EPM techniques by UCITS. It noted the considerable work conducted by ESMA in the context of finalising the ESMA 2012 Guidelines, which are due to be implemented through national regulators early next year.

While the IFIA believes that there are aspects of the ESMA 2012 Guidelines which remain unclear or which industry would like to be clarified or amended, the publication of the ESMA 2012 Guidelines followed a comprehensive consideration of issues relating to the use of EPM techniques (including in particular the composition, quality and diversification of collateral provided to a UCITS and by a UCITS to relevant counterparties). Accordingly, the IFIA asked that, if the Commission is likely to revisit these rules or has particular concerns in relation to this area, it should prioritise consideration of these in advance of the implementation of the ESMA 2012 Guidelines (and to potentially request deferral of the implementation date for the ESMA 2012 Guidelines to allow this process to be completed). This would avoid the costs to UCITS, and ultimately investors, of ongoing and repeated restructuring of operational systems and documentation to meet evolving rules in this area.

OTC derivatives

The Commission queried whether, when assessing counterparty risk, the treatment of OTC derivatives cleared through central counterparties requires clarification and whether OTC derivatives not cleared through central counterparties should be subject to the same collateral requirements that apply to EPM transactions. The UCITS VI Consultation also raised general questions on the current market practice in terms of frequency of calculation of counterparty risk, issuer concentration and valuation of assets.

The IFIA observed that the timeline for the implementation of centralised clearing of derivatives under the European Market Infrastructure Regulation ("EMIR") would need to be considered prior to implementing any of the changes contemplated in the UCITS VI Consultation. In relation to need to clarify the treatment of OTC derivatives cleared through central counterparties when assessing counterparty risk, the IFIA pointed out that the investment manager of an Irish domiciled UCITS is required to determine whether exposure is to an OTC counterparty, the broker or the clearing house and to calculate counterparty exposure accordingly. If the investment manager determines that the exposure is to the clearing house / central counterparty, it would be useful to clarify that such OTC derivatives should be treated the same as exchange traded derivatives ie, they are deemed to be free of counterparty risk.

The response stated that the collateral requirements of OTC derivatives not cleared through central counterparties are consistent with the requirements for EPM transactions and therefore there would appear to be no requirement for further work in this area.

In response to the question whether there are specific operational and other risks resulting from UCITS contracting with a single counterparty, the IFIA pointed out that many of these
risks are addressed by the requirement to obtain suitably collateral which meets the criteria set out in the UCITS Directive. A requirement to transact with a larger pool of counterparties could lead to disadvantages and operational challenges for UCITS in terms of collateral management and could limit the ability to net exposures.

4 Extraordinary liquidity management tools

The Commission raised a number of questions in the UCITS VI Consultation regarding extraordinary liquidity management tools and in particular sought feedback as to what type of internal policies UCITS use in order to face liquidity constraints, whether there is a need to develop a common framework for dealing with liquidity bottlenecks in exceptional cases, and what the current market practice is regarding the use of side pockets.

The IFIA’s response highlighted the various regulatory requirements and the range of tools that are available to UCITS in Ireland to assist them in addressing liquidity constraints and stated its opinion that current practices of Irish UCITS are consistent with the best practices set out by IOSCO. It should be left to the relevant local competent authorities, in conjunction with the local funds industry, to determine how to deal with liquidity bottlenecks. The IFIA recognised that there may be some merit to developing a common framework for dealing with liquidity bottlenecks in exceptional cases provided such a framework permits flexibility. The IFIA stated that it would be very difficult to define criteria to determine an “exceptional case” where temporary suspensions may be allowed and that this determination should be left to the directors’ self-assessment, in conjunction with the investment manager, with a notification being made to the competent authorities.

In response to one of the specific questions raised by the Commission, the IFIA set out that it does not think that time limits on the temporary suspension of redemptions should be introduced. The current mechanism in Ireland for quantitative thresholds and time limits to deal with deferred redemptions works well, is equitable and is in the best interests of all stakeholders in the UCITS. The current system for the execution of redemption orders in normal circumstances operates satisfactorily and any update should focus on exceptional circumstances.

The IFIA suggested that UCITS should be given the ability to use side pockets in respect of assets which become illiquid following investment, provided that the use of side pockets takes account of the existing protections and safeguards in place for UCITS. The IFIA also stated that it would be worthwhile to obtain clarification on the application of the strict diversification rules for UCITS to side pocketed assets.

With regard to the need for liquidity safeguards in ETF secondary markets, the IFIA noted that it would be very difficult to give secondary market investors the same rights as shareholders of an ETF and noted the existing obligation to ensure liquidity through the markets on which ETF shares are listed (including the appointment of a sufficient number of market makers). The response also noted the impact of the ESMA 2012 Guidelines in this area.

5 A passport for depositaries

The question of whether to introduce a depositary passport was raised in the consultations on the UCITS depositary function which preceded the publication of the UCITS V proposals. The UCITS VI Consultation sought further feedback on the advantages and
disadvantages relating to the introduction of a depositary passport. The IFIA response acknowledged that a depositary passport may lead to efficiencies through centralising functions in one location which potentially could lead to lower costs associated with providing depositary services. However, drawbacks may include job losses in a number of Member States. In addition, there could be loss of local knowledge and experience and a concentration of knowledge in one location. The costs associated with the depositary oversight of administration, transfer agency and management activities would increase. It would also be necessary to ensure that no added tax burden is imposed on investors by virtue of a cross border structure, an issue that has arisen in the context of the management company passport introduced under UCITS IV.

The IFIA stated its view that there will be significant technical and operational issues to consider in the course of constructing a depositary passport and that the harmonisation of depositary standards, including eligibility and liability standards as contemplated under UCITS V, together with cross border regulatory standards and supervision, will need to be well established as an important first step in this process. Introducing a depositary passport at this stage may be premature, as the market has not yet had an opportunity to fully assess the benefits and impacts of the management company passport, the UCITS V proposals and the depositary rules under the Alternative Investment Fund Managers Directive ("AIFMD").

**UCITS money market funds**

Consistent with the recent international focus on the reform of money market funds, a considerable section of the UCITS VI Consultation was devoted to questions regarding money market funds. The questions focussed on issues such as the current market practice regarding money market funds, the role they play in the management of liquidity and the extent to which money market funds engage in securities lending and repo arrangements. The UCITS VI Consultation also sought feedback on whether money market funds may represent a source of systemic risk, whether CNAV funds ought to be subject to additional regulation or phased out and how liquidity bottlenecks might be prevented.

The IFIA response underlined the key role of money markets funds as a significant source of short term funding for government, business and financial institutions. It highlighted the fact that money market funds have gained widespread acceptance because of their ease of use, compelling investment benefits and conservative risk profile. They serve investors seeking liquid investment, price stability and diversification of credit exposure. The response stated the IFIA’s belief that money market funds do not represent a source of systemic risk and that the risks they pose to the financial system in Europe are extremely limited. The intrinsic differences between money market funds and traditional banks were emphasised and the IFIA refuted any suggestion that money market funds are banks or “bank-like”.

The IFIA would oppose any proposal to phase out CNAV funds, stating that to do so would needlessly harm investors and increase the cost of funding to issuers without any real risk reduction to the “real economy”. CNAV funds are not particularly susceptible to redemptions; any fund, including a VNAV fund, is prone to redemptions if investors lose confidence in its assets. The IFIA also stated that, given the attractions of money market funds to investors (ie, daily liquidity, price stability), it would be inappropriate to introduce liquidity fees, redemption restrictions and liquidity constraints for money market funds.
The IFIA suggested that the most appropriate regulatory response to the regulation of money market funds would be the development of a globally consistent approach, with common standards applicable throughout the MMF industry agreed to by all the relevant regulators of money market funds on a global basis. Money market fund managers should know their investor base, requiring them to have a deep understanding of the money market fund’s investor profile so they can diversify the investor base and also anticipate redemption cycles which arise from, for example, the need to settle tax liabilities in particular jurisdictions. A regulatory requirement to disclose portfolio holdings on a monthly basis, similar to that applied in the United States, would improve transparency, allow investors to assess risk on an ongoing basis and enable regulators to monitor money market funds more closely.

7 Long term investments

The UCITS VI Consultation requested industry input on whether long-term investments are suitable for retail investors and if there is an appetite for them in the retail market. The IFIA noted that the need for long-term pension planning may result in an appetite for long term investments in the retail market. However, its view was that a stand-alone initiative may be preferable to a modification of existing UCITS rules. This is in order to avoid undermining the focus on liquidity as a key factor for UCITS. In this regard, the IFIA noted that broad concepts and rules within the UCITS framework are appropriate to be used for any retail investor fund structure, including risk management, liquidity management, organisational rules and internal audit. It also believes that provisions should be put in place to allow an investment manager holding a UCITS, MiFID or AIFMD authorisation to utilise such authorisation for the purposes of this “long-term investments” framework.

8 Changes to UCITS VI

The UCITS VI Consultation sought industry feedback as to whether certain areas of UCITS IV require further consideration and possible amendment. These areas include:

(a) Self-Managed Investment Companies

The IFIA welcomed an amendment to Article 31 of the UCITS Directive in order to allow the Commission to adopt delegated acts specifying administrative procedures and internal control mechanisms. The IFIA stressed the importance of the principle of proportionality in their response to the Commission and noted that it is important to recognise the difference in structure and complexity between a management company and a self-managed investment company in the application of the principle of proportionality.

(b) Master-Feeder Structures

The IFIA agreed with the Commission’s proposal that similar information standards should apply (i) where an ordinary UCITS converts into a feeder UCITS; (ii) where a master UCITS changes; and (iii) where a feeder converts into an ordinary UCITS.
(c) **Fund Mergers**

The IFIA agreed with the Commission’s suggestion to amend the UCITS Directive in order to clarify the timeline involved in the authorisation of a merger of two UCITS.

(d) **Notification Procedure**

The IFIA expressed the opinion that the notification procedure has worked well over the last year. However, it agreed with the Commission that it would benefit from certain enhancements. The IFIA were in favour of the Commission’s suggestion to adopt a regulator to regulator approach for subsequent changes to documentation which has previously been notified to host-state regulators through the UCITS IV regime.

**Comment**

While the UCITS VI Consultation process is at a relatively early stage, the extensive terrain covered by the Commission suggests a very broad exploratory mandate with potential long-term implications for the direction of the UCITS product. It is therefore essential that stakeholders engage fully with the consultation process during this embryonic phase.

The partners of the Asset Management Group at Matheson Ormsby Prentice are committed to constructive European engagement on the issues prompted by the UCITS VI review, and to continue to robustly articulate and advocate the position of our clients and the Irish funds industry. Please get in touch with us directly at the contact details provided should you wish to discuss any of the matters raised in this briefing.

Please get in touch with your usual Asset Management and Investment Funds Group contact or any of the contacts listed in this publication should you require further information or legal advice in relation to the matters referred to in this briefing note.
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.mop.ie

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