

Industry developments

The funds industry and the Third Anti-Money Laundering Directive – a specific sectoral guidance note on the Third Anti-Money Laundering Directive has been developed for the funds industry

Changes to anti-money laundering legislation in an effort to combat fraud within the EU have been introduced by Directive 2005/60/EC on the “Prevention of the use of the Financial System for the purpose of Money Laundering and Terrorist Financing” (the Third Directive). The Third Directive proposes a new risk based approach to customer due diligence so that institutions subject to the Directive can target resources at the most vulnerable aspects of their business and also offers the opportunity to lighten the burden in other areas.

Most notably enhanced due diligence must be undertaken in relation to what are known as politically exposed persons (PEPs) - individuals who hold high office particularly in countries where corruption is known to be widespread. The Directive also seeks to ensure that institutions are proactive in carrying out on-going due diligence of their clients’ transactions founded on a clear understanding of the business relationship with the client.

The transposition of the Third Directive will bring Ireland into line with the most recent revision of the recommendations of the Financial Action Task Force ensuring that Irish regulations continue to conform to international standards.

In summary, the Third Directive’s significant reforms include:-

- » the requirement for initial and ongoing “Customer Due Diligence”, which will be simplified in some circumstances and enhanced in others in accordance with a risk based approach;
- » enhanced obligations on designated bodies to take reasonable measures to identify and understand the ownership and control structure of legal entities such as companies and trusts; and
- » the requirement for designated bodies to identify non-domestic PEPs.

A consultation process was put in place to allow interested parties who may wish to comment on the proposed Irish implementation legislation prior to the publication of the draft statute. A working group, including representatives from the IFIA has been working for a number of months on guidance notes to assist companies and individuals falling within the scope of the Directive. The guidance notes comprise a core guidance note applicable to all parties subject to the Directive and sectoral guidance notes applicable to particular industries. A specific sectoral note has been developed for the funds industry.

The guidance reflects the risk based approach in the Directive by offering persons subject to the Directive considerable flexibility in relation to the methods used to identify and verify their customers whether this is on the basis of documents or through electronic searches. This will be a significant change from the current “Passport and utility bill requirement”.

The funds sectoral guidance note advocates that a low risk exposure to money laundering and terrorist financing is an appropriate assessment for the funds industry in Ireland although participants in the industry must be vigilant for specific higher risk situations.

MiFID – Firms still have time to get in line with the requirements of MiFID.

The Markets in Financial Instruments Directive (MiFID) was transposed into Irish law on 1 November 2007 by the European Communities (Markets in Financial Instruments) Regulations 2007 as amended (the Regulations).

The changes introduced by MiFID undoubtedly continue to present significant challenges for those entities falling within scope. The Financial Regulator has however publicly stated that it will afford MiFID firms time to put in place the necessary infrastructure to meet the new requirements. Its approach to assessing compliance in 2008 is on a ‘good faith’ basis i.e. firms must be able to demonstrate that they are endeavouring to bring their systems, processes and procedures into line with the regulations. However by 2009 a ‘best practice’ standard is to be expected of all firms and

failure to meet that standard will result in a regulatory response and possible sanctions.

MiFID can be split into five parts i.e. 1) scope; 2) investor protection requirements; 3) organisational requirements; 4) passporting requirements; and 5) those requirements dealing with the public disclosure of information on trading - known as the transparency requirements. It is these latter requirements which to date have captured most attention given their predicted impact on the structure of the capital markets. The expectation is that arising from MiFID we will see an increase in the number of venues for executing transactions in shares. Why? MiFID seeks to remove all barriers to full competition between execution venues for liquidity. How? By imposing the same regulatory regime on all execution venues whether stock exchanges or any other system for the execution of transactions in financial instruments on a non-discretionary basis. The latter are named "Multi Lateral Trading Facilities" (MTF) by the Directive.

MiFID, in the context of disclosure of information to the public and access to settlement systems, also further shakes up the market by ushering in a new era in relation to trading data. Firstly, it makes much more data available by increasing the public reporting requirements. Secondly, it allows significant flexibility in how that data must be published and thus removes the existing hold that stock exchanges have over trading data. Already a number of UK investment banks, through "Project Turquoise" are establishing their own execution venue or MTF to compete with the London Stock Exchange. The predicted changes to the capital markets are also driven by the "Best Execution" requirements which require firms executing client orders to identify the execution venue which offers the best result for the client, based on the execution factors most relevant to the client and order type in question.

For the funds industry many of the main parties fall outside the scope of the new regulations. Collective investment schemes, trustees/custodians and management companies (as opposed to discretionary investment managers) are exempt from the regulations. However, the provision of investment services by a third party in relation to collective investment schemes does fall within the provisions of MiFID.

The Financial Regulator would also appear to be interpreting subscription and redemption services as outside of scope, which has the effect of excluding administrators and transfer agents. Where the industry is impacted is in relation to the distribution and investment management functions. Indeed, distribution is a particular issue for the industry as a number of products which compete with collective investment schemes for investors do not fall within MiFID (for example insurance products). As a result, in selling such insurance products, investment intermediaries are not subject to the onerous MiFID requirements in relation to inducements and investor protection arising on the distribution of the product. This lack of consistency has been brought to the attention of the EU Commission which is reviewing the issue.

New fast track approval process for promoters – MiFID approved firms can now avail of a fast track approval process.

The Financial Regulator has revised Guidance Note 2/96 - Promoters of Collective Investment Schemes (the Guidance Note). The Guidance Note, which now includes the promoter application form, introduces a fast track approval process for firms which have an authorisation under the Markets in Financial Instruments Directive (MiFID) and credit institutions authorised within the European Economic Area. Such firms will be eligible for the fast track approval process provided the application for approval is accompanied by an up to date confirmation from their home regulator of their regulatory status and provided that the firm has provided all the necessary information to the Financial Regulator as set out in the checklist attached to the revised application form. The Financial Regulator will authorise promoter entities which comply with the fast track procedure process within one week. The Guidance Note also defines the minimum financial resources requirement for the first time and provides that applicant firms must have minimum net shareholder funds of €635,000 or equivalent in another currency.

Side pockets and QIFs

Side pockets in a hedge fund context are a mechanism by which illiquid assets may be removed from the portfolio of a particular fund or sub-fund. They can be a useful mechanism to ensure equality of treatment of shareholders where illiquid assets are held while also segregating and/or eliminating valuation difficulties.

The Irish Stock Exchange has permitted the use of side pockets by listed funds for some years. The Financial Regulator currently only permits the use of side pockets on a case-by-case basis and has no published policy on the subject. An industry submission advocating the use of side pockets for Qualifying Investor Funds (QIF) is currently with the Financial Regulator to seek clarification of existing policy. The submission has been made to draw the Financial Regulator's views on how best to deal with illiquid investments of QIFs and to request them to permit the use of side pockets for these vehicles. The industry submission puts forward the case that the use of a side pocket in certain circumstances is in the best interests of the investors in a QIF. The side pocket mechanism seeks to ensure fair treatment of investors in a fund that finds itself holding an investment that is difficult to value, particularly as it is not always possible for the board to determine a fair value. A response from the Financial Regulator with a statement of its policy on side pockets is expected in due course.