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NEWSLETTER

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IRISH FUNDS ANNUAL GLOBAL FUNDS CONFERENCE

Thursday, 17 May 2018

The Irish Funds Annual Global Funds Conference will be taking place on Thursday, 17 May in the Convention Centre Dublin. View event details / register (www.irishfunds.ie/conference2018).

Now in its 20th year, this annual event brings together hundreds of global CEOs, industry executives, policy makers and regulators to explore and debate the key issues of the funds industry.

At this year's conference

The programme at the 2018 annual conference will include panel and speaker sessions on a variety of topics highly relevant to asset managers, service providers and funds industry professionals. These will range from regulation, distribution, and real assets to diversity, digitalisation and trends for millennial investors. There will also be a focus on Brexit and the implications and opportunities with the withdrawal deadline approaching.

Our keynote speakers this year will include Ruairi O'Healai, International Chief Risk Officer, Morgan Stanley Investment Management.

Government addresses will be given by Paschal Donohoe, TD, Minister for Finance & Public Expenditure and Reform and An Tánaiste Mr. Simon Coveney T.D. Minister of Foreign Affairs and Trade. There will also be an update from Central Bank of Ireland.

As always, the Irish Funds Annual Global Funds Conference promises to be thought-provoking and informative, as well as provide an opportunity to network with other professionals in the industry.

Distribution Workshop

The Irish Funds Distribution Workshop for asset managers, distributors and investors will take place on Friday, 18 May. Registration for this workshop is open to attendees of the Irish Funds Annual Global Funds Conference.

JUMPING OFF THE BREXIT CLIFF – WHEN TO TAKE THE PLUNGE?

Elizabeth Budd, Partner and Marilyn Cooney, Senior Associate, Pinsent Masons

Trends in relation to UK asset managers impacted by Brexit

"We should all be clear that also when it comes to financial services, life will be different after Brexit." This was the sentiment expressed by Donald Tusk in rejecting the hope expressed by the British Chancellor Phillip Hammond to include financial services in an EU/UK trade deal. One of the many changes will be the loss of passporting rights which has made it relatively straightforward to do business throughout the EU for many UK asset mangers. This loss coupled with it being harder to access European capital is at the forefront of UK managers' minds. Notwithstanding the uncertainty that remains, the key determining factor as to when managers take the plunge is timing and the complexity of their proposed license.

Banks and insurance companies were first out of the blocks applying early to the Central Bank for these licenses. As has been widely covered in the media, last year we saw the majority of the larger asset managers choose Ireland as the location for their "SuperManCo" and MiFID applications. Medium & smaller sized managers are closely monitoring developments but many have yet to implement their strategies.

For many, there is still hope that a less hard Brexit could become a reality. However, the looming deadline and lack of clarity around transition periods means that managers should assume a worst case scenario of a hard Brexit, with the UK as a third country and no special deals. They then need to consider whether in these circumstances they can continue to carry on their business relying on a patchwork of access opportunities and delegation. If this is not viable, then a decision needs to be taken on whether to set up within the EU. Ireland is clearly an attractive location for many UK asset managers in terms of ease of access and communication, time zone and workforce considerations.

Post-Brexit licensing options in Ireland

	SELF-MANAGED INVESTMENT COMPANY (SMIC)	SUPERMANCO W/ DELEGATES ('V1')	SUPERMANCO W/ ADD-ON AUTHORISATIONS ('V2')	MIFID FIRM
Authorisation Timeline	Allow 6-8 months (during high volume periods)	Allow 6-8 months (during high volume periods)	Allow 8-9 months (during high volume periods)	Allow 9-10 months (during high volume periods)
Activities (PM = portfolio management, RM = risk management)	Retain oversight of PM and RM but delegate day-to-day activities	Retain oversight of PM and RM but delegate day-to-day activities	Performs day-to-day PM & RM activities	Full range of services
Manage other fund umbrellas?	No	Yes	Yes	Yes
Manage / advise Segregated Mandates?	No	No	Yes, via add-on licenses without need for MiFID delegate	Yes
Substance requirements	• 2 Irish-resident directors • 2-3 Designated Persons [1]	• 2-3 Irish-resident directors [1] • 2-3 Designated Persons [1 2]	• 2-3 Irish resident directors • 2-3 Designated Persons [1] • Chief Investment Officer / Managing Director Head of Risk/Compliance and Finance, internal audit [2]	• Substantive presence required in Ireland [3]
Delegation / Outsourcing	CBI permits delegation of day-to-day PM and/or RM activities	CBI permits delegation of day-to-day PM and/or RM activities	CBI permits delegation of day-to-day PM and/or RM activities	Outsourcing allowed (according to other EEA states or 3rd countries) if in line with applicable law and best practice

[1]Designated persons not all required to be Irish resident and can be directors or employees of the Investment Manager. For 'low' PRISM rated firms, half of the directors and at least 2 Designated Persons performing half of the managerial functions are required to be EEA-resident. For 'medium' PRISM rating firms, 3 directors or 2 directors plus 1 designated person should be Irish resident.
[2]The need for specific roles may differ on a case-by-case basis and depends on the complexity and the number of branches required.
[3]'Substantive presence' for MiFID: the firm's board and management run the firm from Ireland and make decisions in Ireland with sufficient staff and resources to manage the risks.

What are the options?

There are a number of licenses available in Ireland and unfortunately there is no one size fits all approach. **For a full list of options, please refer to the table on the previous page.**

The key factors in determining what license is appropriate for each manager's business is determined by cost, types of activities that they wish to engage in, the amount of substance they can provide in Ireland, what they wish to delegate back to the UK/elsewhere, the number of funds managed and their domicile.

Typically, the larger managers seek the SuperManCo (with ancillary permissions) and MiFID licenses, which have higher substance requirements, with medium to smaller managers considering a self-managed/ delegating SuperManCo license or appointing a third party manager.

What Substance is required in Ireland and what activities can be delegated?

The level of substance in Ireland depends on the type of license being sought. The Central Bank will require that full responsibility is retained and oversight is carried out in Ireland, but does not usually require the performance of the day-to-day activities in Ireland. Similarly, the day to day activities can be delegated back to the UK provided they are properly overseen in Ireland.

For fund management companies (absent MiFID add on permissions) the substance can essentially be met by the board of directors and designated persons. In relation to MiFID entities, the 'head office' requirement needs to be met and this is a matter to be agreed with the Central Bank on a case-by-case basis. For entities seeking ancillary add-on permissions, usually a head of investments, risk/ compliance function is also required, but it varies on a case-by-case basis, depending on complexity.

Conclusion

In order to retain EU passporting rights and access to European capital/ distribution, notwithstanding the uncertainty in relation to Brexit, UK based managers need to urgently consider what options are available to them post Brexit. With potentially just 12 months left, uncertainty in relation to the transition arrangements and a significant number of Irish funds/ UK Managers directly impacted and seeking authorisation at the same time, putting pressure on the Central Bank, managers need to decide now on their Brexit strategy solution and look to implement it within the next 3 months to ensure that they are "day one ready" for Brexit at the end of March 2019.

CRYPTOCURRENCIES: QUESTIONS THE BOARD SHOULD BE ASKING

Ken Owens, Partner, PwC

Financial services firms are seeing increasing demand from their customers for access to Bitcoin and other cryptocurrency-related products, and the capital markets also are confronting a broad set of crypto-related developments.

Given the dynamic nature of the market, the emerging legal and regulatory climate, and the volatility of crypto assets, it can be a daunting task to define the space or even understand the strategic rationale of introducing a cryptocurrency into an organisation.

As the role of the board is to discuss, review, and ultimately approve overall strategy, how can the board engage in constructive dialog about the potential strategic fit of cryptocurrencies?

What are the realistic use cases for our organisation?

Any conversation about crypto assets should start by taking this practical approach to understanding the nature of the business opportunities and risks involved rather than seeing it as a technology project for business units to manage. Several brokerage firms now allow clients to trade the Bitcoin futures product, and additional cryptocurrency financial products could emerge. Other offerings, such as institutional trading and cryptocurrency dedicated funds, could also be on the horizon, while areas such as custodial services are greenfield.

Boards of financial services firms should start by asking management if it can harness cryptocurrencies to increase the value of existing products or services.

How will extreme changes in valuations or volumes (5x-10x) impact the strategy?

Cryptocurrencies such as Bitcoin (BTC), Ether (ETH), and Ripple (XRP) have seen significant increases in trading volume and interest from retail and institutional investors. Given the volatility of cryptocurrencies, boards should ask about market sensitivities and scenario assumptions if inputs were to go up or down by a factor of 5x-10x.

Does management have an effective system in place to model, manage, and balance risks?

Financial services firms evaluating whether or not to enter the market should first take a stance on regulatory and reputational risk. Regulatory uncertainty or the inability to accurately calculate the fair value of a cryptocurrency may prove to be a challenge and will influence decisions whether to proceed.

Boards should press management teams to consider whether adjusting existing risk management systems is adequate or whether new frameworks are needed.

Is internal audit equipped to offer independent assurance of the technology, policies, and controls?

Cryptocurrencies will ultimately introduce exposure to distributed ledger technology (DLT), which presents challenges to the traditional audit approach. Regardless of the promise of the technology, internal audit, risk, or legal teams will still need to test and verify the systems and controls to adequately provide confidence to all stakeholders.

Boards should press management not just on policies and controls surrounding the new technology, but also on whether internal audit teams are properly suited and have the right expertise to perform their jobs.

What are the legal and regulatory guidelines, and how will the organisation monitor emerging regulatory considerations?

The inconsistency and early stage of regulation in the US and globally is arguably one of the greatest challenges to how a board or management should think about participation in these markets. As regulators begin to find their footing, the basics may matter the most—the crypto product, its use, who is using it, and where—to identify the potential regulatory regime.

Has management given proper consideration to the global nature of cryptocurrencies?

With the decentralized technology underpinnings of cryptocurrencies, there is no centralized or regulated oversight of the currency itself. User identification and verification are not native and, as such, management and the board will need to consider proper know-your-customer and anti-money laundering (KYC/AML) compliance.

Is management aware of the tax framework and implications?

Each organisation's exposure to this new asset class will vary significantly depending on the specific role and use case taken. The complexities of the tax treatment should be considered prior to exposure to ensure that the right processes and reviews are in place for emerging or changing tax considerations.

Has management considered the technology and security concerns for cryptocurrencies?

Boards should ask probing questions about the security of cryptocurrency keys. The storage and retrieval of cryptocurrencies is critical and, much like any cybersecurity role, largely underappreciated work. Boards should ask management teams what role their organisations want to take with formal security programs and secure storage of cryptocurrencies, and to quantify risk-reward. A company's specific cyber-risk plan should also be updated for cryptocurrency.

Conclusion

The cryptocurrency market will undoubtedly provide new opportunities to financial services organisations of all sizes and types. When it comes to developing a strategy, however, there is no one answer or way to approach all the issues that must be considered. In the case of cryptocurrencies, the right questions span many parts of the organisation.

HOW CAN INVESTMENT FUNDS COPE WITH THE MIFID II DATA DELUGE

Stephen Carty, Partner, and Deirdre Hennelly, Associate, Maples and Calder

MiFID II [1] introduces a wide range of enhanced reporting obligations for investment firms ("MiFID Firms"). In this article we consider the implications of this for investment funds, primarily from a governance perspective.

The MiFID II Data Deluge

From 3 January 2018 MiFID Firms are obliged to provide their clients with a wide range of data. This is due to enhanced reporting obligations under MiFID II. Clients, for this purpose, include investment funds to which a MiFID Firm acts as investment manager or adviser.

As a brief overview, on either a monthly or quarterly basis in most cases [2], MiFID Firms must provide information to their clients in relation to matters including:

- The valuation of the portfolio;
- Fees and expenses charged;
- A breakdown of the portfolio's composition;
- Information on any corporate actions;
- Performance reporting;
- Information on trades and details of transactions; and
- Cost details for any paid-for research

Notification must be made (by the end of the relevant business day) of any 10% drop in the value of the portfolio.

Key Considerations

So, due to regulatory requirements applying to MiFID Firms, investment funds or their management companies are now receiving a huge amount of data.

This presents a number of issues for the investment funds, primarily from a governance perspective.

What to do with all the data?
The first problem this presents is data review. Who from the investment fund or the management company will review all of the information being sent monthly or quarterly? Has there been an assessment done as to whether any of this data is critical or of higher importance? Or has it been determined that none of the information is likely to present any issues that are not already captured in the existing reporting framework?

If tolerance levels are set and cases arise where data breaches those tolerance levels, the next thing to consider is what action is to be taken and who is responsible for taking this action.

This all points towards formulating a policy/set of procedures for data analysis.

Another question is whether any of this information should be shared with the fund's investors. If, for example, a fund is being provided with detailed MiFID II costs and charges data or data on paid-for research, should the fund inform investors? This data may not actually be informative from an investor perspective. MiFID II costs and charges data, for example, is not reflective of overall fund expenses. Also, investors already receive fund level costs and expenses information in the periodic reports and, in the context of UCITS, ongoing charges disclosure in the Key Investor Information Document.

Disparity of information between investment funds managed by MiFID Firms and non-MiFID firms
If some investment funds are receiving MIFID II data and some investment funds are not, this divergence or "information gap" could have implications for investors. To the extent the data is beneficial, investment funds may seek to get corresponding levels of data from non-MIFID firms to bring them into line.

[1] Directive 2014/65/EU.
[2] There is an alternative reporting model where information is kept up-to-date online and the portfolio manager ensures it is accessed by the client on at least a quarterly basis. This may not be practical where the client is a fund/management company.

Reconciling the new data with the existing reporting framework
As well as considering the information MiFID Firms typically provide to investment funds as part of their existing regular reporting, it is also necessary to consider how new MIFID II data will fit with the enhanced delegate supervision requirements that are coming into effect under the Central Bank of Ireland's revised fund governance framework (commonly referred to as "CP86").

CP86 does not require the granular level detail of portfolio information provided under MiFID II, but it does mandate (i) detailed information to be provided prior to the launch of a new fund/sub-fund; (ii) regular reporting on specific investment management and distribution matters and (iii) comprehensive annual presentations from investment managers.

Also, key performance indicators should be set and there is a new requirement for regular reports to cover operational risk (including any instances of reputational risk and regulatory risk for the delegate).

Enhanced CP86 reporting and MiFID II data disclosure are not likely to overlap to any great degree. But this further highlights the need, from the MiFID Firm's side, to have an enhanced reporting framework. From the fund's/ management company's side, this also highlights a need for an enhanced capability to review, assess and, where relevant take necessary action, arising out of the information reported.

Final Thoughts

In the context of the questions posed in this article, fund boards should engage with MiFID firms they have appointed and consider the implications of the enhanced MIFID II data reporting.

THE IMPORTANCE OF DIVERSITY OF PERSPECTIVE ON BOARDS

Vanora Madigan, Associate Director, DMS Investment Management Services (Europe) Ltd.

It has been shown that one of the most effective ways to enhance corporate governance is through board diversity. In general terms diversity looks at the board composition of individual directors to allow for a balanced board which is the essence of corporate governance. Boardroom diversity covers age, background, gender and ethnic diversity, and also diversity in terms of skills, thinking, competencies, experiences, and careers.

Depth of perspective leads to a better dynamic and manifests in better compliance and corporate governance. Where the directors have different points of view there is less likelihood of "group think", which leads to a more agile board and better performance. Diversity of thinking and perspective assists the board in fulfilling its ongoing oversight responsibilities.

A key benefit of board diversity is more effective decision making. A diverse board with different skills, background, and experiences will look at topics with a broader perspective which leads to more critical analysis and a different board dynamic. Having multiple views on any action and its outcome makes for decision making that is more than likely to take into account the risks and implications of possible actions. This leads to a more thoughtful and considered decision making process and allows for more comprehensive oversight.

A well-constructed board is able to draw upon its wide experiences in foreseeing challenges and appraising risks. This diversity of perspective leads to better risk management as the board can draw upon its diverse set of skills and knowledge. This is essential if boards are to successfully tackle complex issues such as the accelerating use of technology and the growth of Artificial Intelligence.

There has been much discourse on the issue of women's representation on boards and the need for gender diversity at the board table. This has brought about renewed discussions on the broader aspects of diversity such as experience, background, and tenure on the board. What has been shown is that compiling a board with a wide range of perspectives must be a conscious decision and flexibility needs to be considered in selecting board members to make better use of the talent pool.

100 Women in Finance, a global network of professionals in the finance and alternative investment industries, launched in Ireland last year, with a key focus area being female board participation. The 30% Club published in January a study of women in the financial services industry in Ireland where only 37% of participating firms' talent pools were women. It was also found that firms with gender targets at employee level were more confident in their ability to develop, retain and attract female talent. This lends weight to the initiative of creating and cultivating an active pipeline of female participants and widening the scope in terms of candidate selection.

Diversity and inclusion should be matters at the forefront in board selection. In addition to the critical analysis that boardroom diversity can bring, it can also enhance corporate reputation, positively affecting board performance and making for better use of the skill base. It can also be seen that institutional investors are taking into consideration board diversity as a factor for evaluating investment to ensure that interests are aligned. The Irish Funds Corporate Governance Code requires the board to formally review its membership every three years. Board diversity and maintaining a balanced board lends itself to be discussed at this review with a real assessment to be undertaken.

With CP86 we are also seeing the review of the fund board composition and skillset analysed at least annually with meaningful discussion. More boards are attuned to the value diversity can bring which we welcome.

CHECKING THE TIRES – REVIEWING UCITS AND AIFMD

Sean Tuffy, Head of Market and Regulatory Intelligence, Citi Custody & Fund Services EMEA

The EU's review of AIFMD and UCITS offers potential opportunities and pitfalls for the asset management industry. This year, the regulatory frameworks that govern EU investment funds, Undertakings for Collective Investment in Transferable Securities (UCITS) and Alternative Investment Fund Managers Directive (AIFMD), will be reviewed by EU policymakers. These reviews offer potential opportunities and pitfalls for the asset management industry.

Cross-Border Distribution Issues

A major policy initiative in the EU is the ongoing work on the Capital Markets Union (CMU) project. The CMU's objective is to strengthen the EU's capital markets to encourage more cross-border activity.

As part of the CMU work, the European Commission has been looking for ways to encourage more cross-border sales of UCITS and AIFMD funds. Despite its global success, there are still challenges in selling UCITS across the EU due to a number of local barriers. These include fees imposed by local regulators, additional national requirements around selling financial products, and local paying agent requests to process subscriptions and redemptions.

AIFMD funds face these challenges and more. For example, the local language requirements for documentation, such as applications or prospectuses, vary by country. A further complication is that the timeline for passport approvals is not uniform.

The cumulative effect of these rules is additional costs for investors and less efficient distribution across the EU for both UCITS and AIFMD funds.

For asset managers, the focus on improving cross-border distribution will be welcome. The question is how quickly action can be taken. For UCITS funds, it is a matter of fine-tuning certain elements. On the AIFMD front, removing the barriers to distribution requires heavier lifting, which may entail changes to the primary legislation.

UCITS Substance Rules

One of the potential flashpoints in the UCITS review is the substance requirements in the framework. Currently, the UCITS framework does not contain substance rules. Instead, the substance requirements are determined by the local regulators, which decide the appropriate level of governance and oversight for the UCITS funds they authorise. In practice, this has led to a lot of asset management activities, including portfolio management, being delegated to authorised managers in countries outside of the fund domicile.

However, there are some EU policymakers who would like to see this changed and have the UCITS rules incorporate third-country provisions. These provisions would govern what activity can be conducted in non-EU countries, and what must be done within the EU. The catalyst for this push is the UK's decision to leave the EU. A large percentage of the assets held in UCITS funds are managed from London. Some policymakers think that once the UK exits the EU it should no longer be able to be a major asset management hub for European funds.

Any changes to the UCITS substance rules could have a significant impact on the global asset management ecosystem. UCITS funds have become a truly global product without third-country provisions. UCITS funds domiciled in Ireland or Luxembourg are just as likely to be managed in New York or Hong Kong as they are in London or Paris. The industry is concerned that any changes made to restrict the UK's ability to manage UCITS may have unintended global ramifications.

Closing the MiFID Loophole

In the run up to the implementation of Markets in Financial Instruments Directive (MiFID) 2, a number of high-profile hedge funds exchanged their MiFID authorisation for an AIFMD authorisation. By changing to the AIFMD license, hedge funds can avoid MiFID 2's detailed transaction reporting and annual public trading execution disclosures. This move did not go unnoticed by policymakers. Markus Ferber, the chief architect of MiFID 2, has noted that he expects the differences between AIFMD and MiFID 2 to be closed as quickly as possible.

Given one of the key policy goals of regulators is to reduce so-called regulatory arbitrage, the use of AIFMD to avoid MiFID 2 reporting requirements is likely to be short lived.

Marathon, not a Sprint

The process of changing the AIFMD and UCITS rules will not be quick. A key factor in any timeline is what elements can be enacted tactically, without amending the primary legislation. For example, removing some of the UCITS distribution barriers probably will not require legislative changes.

However, closing the AIFMD-MiFID loophole or creating a third-country regime for UCITS would require alterations to the regulatory frameworks. These reviews ultimately may lead to AIFMD 2 and UCITS 6, which would be multi-year efforts.

Given the potential impact of some of the proposals, this extended timeframe will certainly be welcomed by the industry. Since it is only the beginning of the review process, asset managers should be engaged from the outset to ensure their voices are heard as new proposals are drafted.

TAX TRANSPARENCY – AN OPPORTUNITY OR THREAT?

Sinéad Colreavy, Director, Business Tax Advisory, EY

Transparency is the common thread underpinning the current significant global tax changes and lack of transparency, rightly or wrongly, is perceived as an indicator of tax evasion. The Irish funds industry, as a facilitator of global collective investment funds, is a key player in ensuring Ireland maintains its reputation as a globally tax transparent jurisdiction. Embracing transparency and ensuring compliance presents a real opportunity for our industry and for participants to differentiate themselves.

Ireland's tax system is recognised as a global leader on transparency. The OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes gave Ireland the highest possible transparency rating following a second peer review that looked at Ireland's compliance with international standards for the exchange of information between tax authorities.

Consider the following questions - what happens when a fund reports details to Revenue in connection with an investor and those details are passed on to the tax investor's home jurisdiction and those details do not match that investor's tax return? Most likely that investor will become subject to closer scrutiny from their home tax authority. Happy investor? Real business risk? Tax evasion? Inaccurate reporting? Lack of governance over tax data?

Exchange of information between tax authorities is already happening. The correct management of tax is increasingly linked to reputation. Companies and entities are asking if their brand and reputation is protected. The benefit of

Directors becoming savvier in connection with tax risk being a real business risk is twofold. Organisations ensuring compliance, as well as protecting reputation, will be more attractive to tax aware investors. Increasingly investors only want to work with partners that are doing the right thing, and being seen to do the right thing, with regard to taxation, and want to avoid being tainted by association with inefficient and potentially inaccurate tax reporting. Getting to grips with transparency requirements allows organisations to go to clients with an affirmative view that they are fully engaged with, and highly proactive on, the issue of tax. Investors will have no tolerance for organisations that can't deal with the demands of taxation authorities.

Getting the balance right between over managing and not managing tax risk is a challenge facing many Boards. Effective implementation and governance of transparency is required to ensure we maintain our reputation as leading jurisdiction for facilitating global collective investment funds.

While the fund is ultimately responsible for its tax obligations, management of tax is generally outsourced to a third party provider as approved by the fund's Directors. Directors need to ensure they are satisfied that the business risk associated with tax is identified and managed. In addition to legislative requirements how transparent is tax governance? As investors become more engaged with tax they will demand to understand the impact of tax on their investment portfolio. Tax uncertainties or tax adjustments will drive business towards providers that offer tax transparency as well as certainty and products that reflect investors' tax profiles.

Quite simply the key question from a tax perspective should be, does your organisation have an up-to-date tax governance model in place? The response will indicate whether tax risk is being treated as real business risk. Best in class organisations will be able to produce a tax policy, a governance model, an operating manual that includes the obligations of the fund, mapped to responsible parties backed up by current service level agreements that clearly set out respective roles and responsibilities, a compliance calendar, risk assessment for new products and escalation procedures etc.

The current market response is highly fragmented. Many current fund structures were not set up with transparency as a consideration. We routinely ask clients for their tax policy and governance framework. The spectrum of responses is often telling. However it is encouraging to see more and more clients consider how this assurance can be achieved in practice and how this assurance can be provided to the various stakeholders – investors, boards of directors, tax authorities etc.

How your organisation chooses to handle tax risks should be viewed as an opportunity as it will be a key differentiator in attracting business. The quality of an organisation's tax infrastructure should be seen as an alpha characteristic and key enabler of growth – this equally applies to funds, fund service providers and asset managers.

ENHANCED OPPORTUNITIES FOR LOAN ORIGINATING FUNDS

Mark White, Partner, and Imelda Higgins, Senior Associate, McCann FitzGerald

In October 2014 the Central Bank of Ireland (CBI) introduced the first bespoke regime for loan originating investment funds in the EU. This was widely welcomed as a very significant development, both in terms of fund innovation and in terms of providing increased sources of financing for the Irish economy.

The CBI's regime allows loan originating qualifying investor alternative investment funds (L-QIAIFs) to engage in direct lending activities, subject to complying with certain conditions. Since its introduction, the CBI has amended the L-QIAIF regime on two occasions, with the most recent amendment taking effect on 7 March 2018. This amendment significantly enhances an L-QIAIF's ability to invest in a broad range of fixed income and credit securities, and is likely to make Ireland a more attractive jurisdiction for managers seeking to engage in loan origination and broader credit activities.

Developing the L-QIAIF Regime

The Alternative Investment Fund Managers Directive (AIFMD) does not address the issue of loan originating funds, leaving it to the EU Member States to decide whether or not to allow alternative investment funds to engage in direct lending.

The CBI published a discussion paper on Loan Origination by Investment Funds in July 2013, followed by a consultation paper a year later.

Subsequently, the CBI developed a bespoke framework for L-QIAIFs which is set out in the CBI's AIF Rulebook. Under this framework, L-QIAIFs are subject to the general rules applicable to all QIAIFs. Among other things, this means that an L-QIAIF must have a minimum initial subscription of €100,000 or greater and that it can only be marketed to "Qualifying Investors" as defined in the Central Bank's AIF Rulebook. L-QIAIFs are also subject to certain additional requirements, designed to mitigate the risks which are commonly perceived to be associated with them.

Expanding the Limited Purpose Rule

The additional requirements applicable to L-QIAIFs include a so-called "limited purpose" rule, which restricts the type of activities that an L-QIAIF can carry on.

Currently, the limited purpose rule means that L-QIAIFs are only allowed to invest in
a) loan origination and acquiring participations in loans on the secondary market;
b) debt and equity securities of entities or groups to which the L-QIAIF lends;
c) instruments which are held for treasury, cash management or hedging purposes.

On 7 February 2018, the CBI published a Notice of Intention to a rule change to the AIF Rulebook, in which it signalled its intention to allow an L-QIAIF to invest in any type of debt or credit instrument from 7 March 2018. As a result, since that date an L-QIAIF can invest in a broad range of fixed income and credit securities as part of its overall investment strategies and is no longer restricted to debt/credit instruments of entities or groups to which it has lent money. This is in addition to the L-QIAIF carrying out each of the other types of investments mentioned in the preceding paragraph.

Authorisation and Passporting

We expect that the recent expansion of the limited purpose rule will greatly enhance the attractiveness of Ireland's L-QIAIF regime.

Those interested in establishing an L-QIAIF will need to apply to the CBI for authorisation and demonstrate compliance with the requirements set out in the AIF Rulebook. L-QIAIFs benefit from the QIAIF fast-track approval process, which means that an L-QIAIF can be authorised by the CBI in 24 hours. Once authorised, it will be possible to market the L-QIAIF throughout the EU, under the AIFMD marketing passport.

Conclusion

The CBI's recent amendment of the limited purpose rule suggests that it is becoming increasingly comfortable with the benefits associated with L-QIAIFs, and less concerned about the risks associated with permitting L-QIAIFs to pursue an investment strategy that includes a broad range of fixed income and credit securities.

The aim of the EU Capital Markets Union (CMU) is to create deeper and more integrated capital markets across the EU by reducing fragmentation in financial markets, diversifying financing sources, strengthening cross border capital flows and improving access to finance for businesses. A key part of CMU involves the development of an appropriate EU framework for loan origination and addressing barriers to lending for non-bank entities. Loan originating funds therefore have the potential to make a valuable contribution to growing capital markets and providing alternative sources of funding to market participants. Loan origination funds also offer the opportunity to allow investors to gain exposure to this increasingly popular asset class in a diversified and cost-effective manner.

NEW RULES OF ENGAGEMENT: ADAPTING FOR GROWTH IN ALTERNATIVES

Robert Keogh, Senior Managing Director,
Head of AIS EMEA, State Street

As the investment industry environment transforms faster than ever before, alternative asset managers' ability to adapt their business models is being tested to the extreme.

Institutional investors now outweigh high-net-worth individuals as a source of hedge fund capital, and they continue to grow their allocations in other unlisted assets[1]. This influx of institutional money puts new demands on alternative managers. These sophisticated clients are intensely focused on how fees are assessed, how investments are run and how risk-adjusted performance is reported.

Further, as the alternatives sector expands, the days of light-touch regulation are over. Regulators have the alternatives sector firmly in their sights, driving managers to restructure funds and rethink how they communicate and report to clients. As regulatory pressures grow, fast-evolving technologies present both opportunity and risk: robotic automation and artificial intelligence (AI) can drive operational efficiency and enhanced investment insight — but they will challenge late adopters.

According to State Street research, more than half (52 percent) of alternative asset managers fear they will need to overcome significant operational inefficiencies to sustain growth for their firms.[2] And 69 percent recognize that if they don't improve operational agility, their competitors will be better-placed to capture growth opportunities. The environment is changing fast and only those that adapt at pace will thrive in it.

No room for complacency

Driven by the need for better long-term returns and portfolio diversification, institutions have increased their bets on alternative assets over the last two decades. Since 1997, average allocations to real estate and other alternatives by pension funds in seven of the world's largest pension markets has risen from 4 percent to 24 percent.[3] And the total assets managed by the world's 100 biggest alternative managers reached $3.6 trillion in 2016, up 3 percent from 2015.

Against the backdrop of this impressive trajectory, 58 percent of alternative managers are confident that they will achieve their growth objectives over the next year. Future growth is far from guaranteed, however.

The global hedge fund industry saw net outflows of $102 billion in 2016 as performance and fee concerns drove some institutional investors to pull their capital.[4] The growing dominance of institutional money in the alternatives market means that managers will need to work harder to find opportunities as global competition for high-quality assets intensifies. And the complexity of the regulatory environment is increasing the challenge of meeting investor needs. With regulation governing liquidity risk and regulatory focus on investment fees cited as the two biggest perceived macro-environmental threats to their growth prospects over the next five years[5].

Though institutional investors' appetite for alternatives is increasing overall, there are distinct hurdles to greater illiquid holdings for some investors. In the pensions market, for example, illiquid holdings may limit pension funds' ability to undertake buy-in and buy-out transactions, while rule changes in markets such as the UK are increasing demands from scheme members for lump-sum pay-outs. Alternative managers will need a detailed understanding of individual client pressures to allay such concerns.

Meanwhile, regulations such as the Alternative Investment Fund Managers Directive (AIFMD), Markets in Financial Instruments Directive II (MiFID II) and Dodd-Frank continue to increase the cost of compliance for hedge funds and private equity and real asset (PERA) firms as they require more detailed reporting both to regulators and investors.

The growth shortfall

These considerable challenges mean alternative managers will need to reconfigure their operating models and develop new competencies if they hope to capture the growth opportunities on the horizon.

According to State Street research, there are three main areas of critical importance for the long-term growth of the alternatives sector, including their:

1. Ability to extract meaningful insights from data
2. Ability to manage technology risks
3. Having a strong governance framework in place

[1] Preqin, Hedge Fund Manager Outlook, June to December 2017
[2] State Street, A New Climate for Growth: Adapting Models to Thrive is based on a survey of more than 500 institutional investors and asset managers worldwide, focused on these institutions' priorities for growing their assets, businesses and improving their investment performance over 1-5 years. Based on this survey's results it highlights key conclusions that outline the strategies and models necessary to achieve these growth aims.

Developing sophisticated investment and risk analytics is a key concern for alternative managers as they seek to deliver better yields, uncorrelated returns and effective risk management. And as their environment becomes more tightly regulated – and institutional investors seek closer control over the management of their assets – alternative managers recognize that stronger governance will be necessary. This means putting robust processes and controls in place at both the fund and firm levels, and ensuring clear separation of responsibilities between front-, middle- and back-office personnel.

Playing by new rules

As a whole, the alternative asset management sector boasts a healthy growth trajectory over recent years. But with more capital coming into the sector, the ability of hedge funds and PERA firms to adapt their operating models has never been so profoundly tested.

Our research finds a sector that is bullish about its growth prospects, but aware of the significant challenges that lay in store. Leading managers appear to be rewriting the rules for engaging investors – working toward more customized solutions. Whilst forging integral partnerships with providers that can help them fulfil their growth ambitions and ensure they have a strong governance and risk management framework.

[3] Global Pension Assets Study 2017, Willis Towers Watson
[4] 2017 Preqin Global Hedge Fund Report, Preqin
[5] Alternative asset manager respondents include hedge funds, fund of hedge funds, private equity and real estate funds

THE IRISH FUNDS INDUSTRY AND AIFMD

Irish Funds Alternative Investment Steering Group

The introduction of the Alternative Investment Fund Managers Directive (AIFMD) in June 2011 represented a material change in the way that alternative investment funds were to be regulated across EMEA. Specifically, the Directive created new obligations and liabilities on the Manager (AIFM) and the Depositary (formerly known as a Trustee / Custodian) and created some new regulatory reporting obligations on the fund and manager.

The Irish industry collaborated with the Irish Central Bank and Department of Finance to successfully implement the regulation into Irish law, and to create a set of industry guidance notes around key topics.

At the time of implementation, the Directive initially contemplated a review of key provisions, particularly around the concept and execution of how funds and managers located in "Third Countries" (i.e. outside of the EU) could interact with EU funds, managers and investor.

The Directive required that the review would commence by July 22, 2017 and we now welcome the consultation process commenced by the Commission.

The Irish industry is of the view that AIFMD has broadly worked well; however a number of key issues have remained unresolved, and a number of unintended consequences have presented in the period since implementation.

The importance and urgency of these items has been brought into sharp focus by the decision by the UK to leave the European Union. Within a European context, the importance of the UK fund management industry cannot be overstated, and the Irish industry, while regretting the decision of the UK, remains committed to both maintaining a regime that is compliant with EU regulation and legislation, while at the same time, ensuring that Ireland continues to provide a world class product suite that will continue to be of value to UK managers and investors.

Specifically, the Irish funds industry has been consulting with asset managers and investors and will be recommending via the consultation process that the following areas of AIFMD be included in a review. We will also, of course welcome any and all commentary from impacted asset managers.

Third Countries
The requirements and transition processes around third counties will need to be clarified, especially as we are now facing a large number of AIFMs, AIFs and distribution arrangements which will be potentially migrating from being an EU activity to a Third Country activity.

A number of the provisions around Third Country marketing are unclear – specifically in terms of how "reverse solicitation" might be interpreted and the precise terms under which a non EU AIFM of a non EU AIF might market in the EU.

We also note that the policy intention around extending the marketing passport to Third Country AIFs and AIFMs remains unconfirmed.

Depositary
We note that the depositary provisions are unclear in the context of how a depositary is required to supervise the activities of a Prime Broker – specifically we are advised that a US Prime Broker in many instances cannot complete the requirements of Article 90.

We also note the potential for a depositary to "discharge" liability in certain situations – however, the circumstances where the authorities view that such "discharge" might be appropriate remain unclear.

AIFM
We are advised by a number of asset managers that Annex IV reporting requirements are not standard across the EU, with one result being that certain AIFMs are being required to file multiple Annex IV variations in different jurisdictions.

We will be recommending that the Commission ensure that, particularly in the context of Brexit, that a sensible regime for investment management and risk management "delegation" will be retained.

The Irish funds industry is committed to retaining our position at the top of leading fund domiciles and will continue to engage with the industry, regulatory bodies and government agencies with a view to continuing to further the business objectives of our client base and their investors.

Irish Funds
Ashford House,
18-22 Tara Street, Dublin 2

t: +353 (0) 1 **675 3200**

e: info@irishfunds.ie
w: irishfunds.ie

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