DILLON EUSTACE

29 June 2018

By email only to fundspolicy@centralbank.ie

Central Bank UCITS Regulations Consultation
Markets Policy Division
Central Bank of Ireland
PO Box 559
Dublin 1

Re: Consultation on amendments to (and consolidation of) the Central Bank UCITS Regulations ("CP119")

Dear Sir/Madam

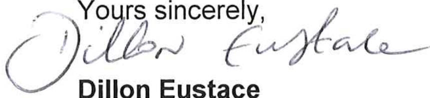
We are writing to you in response to the Central Bank's invitation in CP 119 to provide comments on the proposed changes to the Central Bank UCITS Regulations 2015 (as amended) (the "**Central Bank UCITS Regulations"**).

We very much welcome the opportunity to provide our input and that of certain of our clients on the proposed changes to the Central Bank UCITS Regulations. We also welcome the consolidation of the Central Bank UCITS Regulations 2015 and subsequent amending regulations into one consolidated piece of legislation which we believe will greatly assist all stakeholders in navigating the Central Bank's domestic rules applicable to UCITS management companies and UCITS funds.

We have provided our commentary on the proposed changes to the Central Bank UCITS Regulations in Appendix I to this letter and would be happy to meet with the Central Bank if you would like to discuss any of the matters highlighted therein in further detail.

With kind regards.

Yours sincerely,



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Appendix I

Section I: Amendments arising from a review of the Central Bank UCITS Regulations

Question 1: Stakeholders are requested to indicate whether they agree with the changes proposed and to provide any comments and/or observations.

Dillon Eustace response:

(i) Regulation 42 of the proposed Central Bank UCITS Regulations codifies existing Central Bank guidance[1], providing that a UCITS may be subject to an annual management fee calculated on the initial offer price per share of the relevant UCITS provided that (a) the UCITS is a structured UCITS which provides a pre-defined return to investors and (b) the fee charged is a percentage of the initial offer price per share of the UCITS.

We suggest that Regulation 42 be revised as follows for the reasons outlined below:

> *"A responsible person shall ensure that where a UCITS **is subject to** ~~charges~~ an annual management fee **or any other fee payable to a service provider of the UCITS which is discharged directly out of the assets of the UCITS and which is** calculated on the initial offer price per share of the UCITS –*
> *(a) the UCITS is a structured UCITS which provides a pre-defined return to investors **or otherwise incorporates an element of capital protection**, and*
> *(b) the fee charged is a percentage of the initial offer price per share of the UCITS*

The reference to "charge" in Regulation 42 indicates that it is the UCITS which charges the management fee rather than it being a fee which is imposed on the UCITS by the relevant management company in return for the provision of management services to the UCITS. Therefore we would suggest that the wording is clarified to reflect this fee structure.

The revised wording also provides for the flexibility of service provider fees other than those of the manager to be calculated based on the initial offer price rather than being based on the net asset value of the relevant share class, noting that this is a practice which has been approved by the Central Bank for certain existing UCITS. As you will be aware, the reason for basing the charging structure on the initial offer price rather than on the net asset value of the relevant class is to allow the fund manager to determine, at the outset, the fees being borne by the UCITS, thus allowing it to determine the fixed payments which the UCITS will receive at a future date under, for example, the terms of a swap (embedding a put option) which is entered into. This in turn will allow the UCITS to provide an element of capital protection whereby the UCITS aims to protect its net asset value as a percentage of its initial offer price or may allow the UCITS to ensure that a minimum dividend payment can be paid to shareholders. It is for this reason that a UCITS which may provide some element of capital protection or minimum dividend payments should be permitted to agree fees with each of its service providers based on the initial offer price instead of limiting this arrangement solely to the fee arrangement agreed by the UCITS with the manager as is currently proposed under Regulation 42 of the proposed Central Bank UCITS Regulations.

The wording of Regulation 42 of the proposed Central Bank UCITS Regulations restricts this fee arrangement to structured UCITS which provide a pre-defined return. As you will be aware, structured

[1] Letter from the Financial Regulator to industry dated 16 August 2006 entitled "Annual management fees within authorised collective investment schemes"

UCITS are defined as those UCITS which "*provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance, or to the realisation of price changes or other conditions, of financial assets, indices or reference portfolios or UCITS with similar features*"[2]

The existing Central Bank guidance clarifies what it means by a specific return, stating that it will comprise "*for example, a guaranteed return or an element of capital protection*". In this regard, we submit that UCITS which are not approved by the Central Bank as structured UCITS within the meaning of Regulation 36(1) of the Commission Delegated Regulation 583/2010 but which incorporate certain characteristics similar to those of a structured UCITS such as providing for an element of capital protection or minimum dividend payments should be able to agree fee arrangements with their service providers based on the initial offer price instead of the net asset value. As noted above for example, the notional amount payable to the UCITS under the terms of the swap (which must be entered into in order to allow the UCITS to seek to provide an element of capital protection or minimum dividend payments to its investors) will need to be fixed at the outset in order to properly implement the capital protection element of, or to facilitate the minimum dividend payments by, the relevant UCITS. As a result, the UCITS will need to ensure that the fees payable to its service providers are based on a fixed amount rather than being based on a figure which can fluctuate. We would note in this regard that the Central Bank has to date permitted a number of such non-structured UCITS to implement this fee structure.

(ii) Regulation 95(3)(b) of the proposed Central Bank UCITS Regulations provides that a UCITS management company must file its accounts covering the full twelve months of the relevant financial year within one month of the end of the relevant period. Noting that there is no rationale provided by the Central Bank for reducing the time-frame for filing the accounts with the Central Bank from within two months of the relevant financial year end to within one month of the financial year end, we would submit that this timeframe is unduly restrictive, noting also that the Central Bank only requires that the first set of accounts covering the first six months of the year be filed within two months of the period end.

(iii) Regulation 105(10) of the proposed Central Bank UCITS Regulations sets down that certain provisions of Regulation 105 apply to externally managed UCITS funds (being those investment companies that have designated a management company).

As currently drafted, an externally managed UCITS investment company must comply with the requirement set down in Regulation 105(5) which provides as follows:

"A management company shall conduct a preponderance of its management in the EEA or such other country as the Bank may, taking into account criteria regarding effective supervision, determine and advise by notice published on the website of the Bank. Such determination may be changed, including if circumstances change."

Our understanding is that the purpose of this wording is to address the "location rule" which applies to management companies and to self-managed investment companies but does not apply to externally managed investment companies which have designated a management company. We therefore suggest that Regulation 105(10) be revised accordingly to remove reference to Regulation 105(5). Furthermore the wording should also be revised to reflect that the cross-reference to paragraph 6 in Regulation 105(4) should not apply to externally managed investment companies.

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[2]Regulation 36(1) of Commission Delegated Regulation 583/2010

(iv) As previously communicated with the Central Bank, Dillon Eustace submits that Regulation 108(2)(a) should be subject to a materiality threshold, similar to the notification obligations imposed on a depositary pursuant to Regulation 114(3) and (4) of the current Central Bank UCITS Regulations[3] and similar to the notification obligations imposed on both retail AIF and QIAIF funds under the AIF Rulebook[4]. In addition, it is submitted that Regulation 108(2)(c) of the proposed regulations should also be amended to introduce a materiality threshold, consistent with the materiality obligation imposed on AIFM under the AIF Rulebook which requires AIFM to notify the Central Bank in writing of "*the commencement of any significant legal proceedings by or against the AIFM*" (emphasis added).[5]

(v) Finally we would suggest that the requirement under paragraph 22 of Schedule 7 and paragraph 15 of Schedule 8 to the proposed Central Bank UCITS Regulations be revised to clarify that the annual and semi-annual reports of the relevant UCITS disclose those classes which have been in issue at any time during the relevant period rather than being required to list both launched and unlaunched share classes. The objective of such disclosure is presumably to highlight to investors those share classes which, during the relevant reporting period, posed a contagion risk to other share classes within the same sub-fund and so details of unlaunched share classes will be superfluous in meeting such objective.

Section II Amendments to UCITS Share Class Provisions

Question 2: Stakeholders are requested to indicate whether they agree with the changes to the share class provisions as currently proposed.

Dillon Eustace response:

(i) Regulation 27(3)(a) of the proposed Central Bank UCITS Regulations requires the responsible person to ensure that "*under-hedged positions do not fall below 95 per cent of the net asset value of the hedged currency share class*". We would note that this is not consistent with the wording set down ESMA's Opinion on Share Classes of UCITS[6] (the "**ESMA Share Class Opinion**") which provides at paragraph 26 (c) that under-hedged positions cannot fall short of "95% of the portion of the net asset value of the share class which is to be hedged against currency risk". Furthermore, the proposed wording set down in Regulation 27(3)(a) is inconsistent with the provisions of the existing guidance published by the Central Bank[7] (the "**Central Bank Web-Based Guidance**") which remains faithful to the wording set down in the ESMA Share Class Opinion and the Central Bank Web-Based Guidance. We therefore suggest that the wording in Regulation 27(3)(a) of the proposed Central Bank UCITS Regulations be revised to make it consistent with the wording set down in the ESMA Share Class Opinion. Appropriate amendments should also be made to Regulation 74(3)(c)(ii) of the proposed Central Bank UCITS Regulations.

(ii) We suggest that Regulation 27(3)(g) of the proposed Central Bank UCITS Regulations is revised for sense to provide as follows (which we would note mirrors the wording set down in the Central Bank Web-Based Guidance and reflects the wording of the ESMA Share Class Opinion):

[3] This materiality threshold applicable to notifications made by the depositary has been retained under Regulation 119 (2) and (3) of the proposed Central Bank UCITS Regulations.
[4] Paragraph (i)(5) of Section 2 of Chapter 1 of the AIF Rulebook and paragraph (i)(5) of Section 2 of Chapter 2 of the AIF Rulebook, accessible from https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/aifs/guidance/aif-rulebook-march-2018.pdf?sfvrsn=4
[5] Paragraph (vii)(1) of Chapter 3 of the Central Bank's AIF Rulebook.
[6] ESMA's Opinion on Share Classes of UCITS dated 30 January 2017, accessible from https://www.esma.europa.eu/sites/default/files/library/opinion_on_ucits_share_classes.pdf
[7] https://centralbank.ie/regulation/industry-market-sectors/funds/ucits/guidance/ucits-and-aif-share-class-hedging

"implement stress tests to quantify the potential impact of losses on all share classes within the UCITS that are due to losses relating to share-class specific assets ~~in the event of a share class exceeding~~ that exceed the net asset value of the respective share class. The results of such stress test shall be made available to the Central Bank on request".

(iii) Regulation 27(4) of the proposed Central Bank UCITS Regulations provides that the stress-testing which must be carried out under Regulation 27(3)(g) should be conducted in accordance with the stress testing requirements set down in Regulation 22 which must ordinarily only be met where a UCITS fund is using VaR to calculate global exposure arising from its use of derivatives. Noting that there is nothing in the ESMA Share Class Opinion which sets down the parameters of the stress testing to be conducted, we would submit that to impose the stress testing requirements set down in Regulation 22 on a UCITS fund in respect of its hedging at share class level is unduly burdensome for UCITS funds, particularly in the case of UCITS funds whose global exposure arising from the use of derivatives is measured using the commitment approach.

Section III: Performance Fees

Question 3: Stakeholders are invited to provide comments and observations on the performance fee provisions being included in the Central Bank UCITS Regulations.

Dillon Eustace response:

(i) Under the proposed changes to the CBI UCITS Regulations, it is only possible for a UCITS to adopt one of the two performance fee methodologies set down in proposed Regulation 41.

We would suggest that Regulation 41(1)(a) is revised as highlighted below (with additional wording highlighted in underlined bold text) for the reasons outlined below:

"41 (1) A responsible person shall ensure that performance fees are only payable by the UCITS on –

(a) Achieving a new high net asset value per share over the life of the UCITS; ~~or~~
(b) the out-performance of an index; or;
(c) in circumstances other than those set out in sub-paragraph (a) or (b) where the relevant performance fee methodology has been accepted by the Central Bank"

The revised wording proposed above provides the Central Bank with the flexibility to allow existing UCITS to continue to use other performance fee methodologies which vary from those described in Regulation 41 and which have to date been permitted by the Central Bank without such UCITS having to seek a waiver from the Central Bank from the application of Regulation 41(1), (2) and (3) of the proposed Central Bank UCITS Regulations.

The addition of the above wording will also allow newly established or existing UCITS to apply another performance fee methodology which satisfies such conditions as may be imposed from time to time by the Central Bank, thus affording UCITS the flexibility to, for example , adopt a fulcrum fee arrangement which we would note is permitted under the final report published by IOSCO entitled "*Good Practice for Fees and Expenses of Collective Investment Schemes*" (the "**2016 IOSCO Report**").

(ii) We note that proposed Regulation 41(3)(a) does not reflect the exact provisions of the existing web-based guidance of the Central Bank on performance fees. While the web-based guidance requires the responsible person to be satisfied that the chosen benchmark is "relevant in the context of the UCITS policy", proposed Regulation 41(3)(a) requires that the responsible person ensures that the index is

consistent with the UCITS investment policy. In order to avoid any possible ambiguities by changing the existing wording, we suggest revising Regulation 41(3)(a) to reflect the current web-based guidance. In the alternative, it would be helpful if the Central Bank could issue guidance explaining the distinction between the two provisions (if any).

(iii) We note that Regulation 41(4) of the proposed CBI UCITS Regulations provides that the calculation of performance fee cannot crystallise more than once a year and that the performance fee is not paid more than once a year.

We would note at the outset that some clients whose UCITS funds which have performance fees which currently crystallise more frequently than annually have highlighted that crystallisation on a more frequent basis than annually works to mitigate the scenario whereby an investor who enters the UCITS may benefit from accrued performance fees in circumstances where the net asset value of the relevant class subsequently decreases and part of the decrease will be off-set by the decrease in accrued performance fees which were deducted from the assets of the fund before the investor acquired its shares in the UCITS. Some of those clients have also noted that payment of performance fees on an annual basis would not be problematic provided that crystallisation is permitted on a more frequent basis than annually as currently proposed.

Separately, we note that the rationale provided for the introduction of annual crystallisation is to "*align the Central Bank's approach to the IOSCO Good Practices*". The 2016 IOSCO Paper indicates that the purpose of this requirement is to ensure that a performance fee does not "*create an incentive for the CIS operator to take excessive risks in the hope of increasing its own remuneration*"[8]

(a) ***General disapplication of annual crystallisation requirements for UCITS funds***

As you will be aware the 2016 IOSCO Paper provides that this requirement should apply in all cases "except when the CIS operator uses a fulcrum fee model". However we would note that the 2016 IOSCO Paper clearly applies this rule only to performance fee methodologies which are based on the outperformance of an index.

We would therefore submit that the annual crystallisation should not apply to UCITS funds who have adopted an alternative performance fee methodology such as a high-watermark methodology as it was not IOSCO's intention to apply this crystallisation rule to funds which adopt a high-watermark methodology. This is clear from the various references to "benchmark" in the box entitled "Good Practice 3" which sets down the annual crystallisation rule.

Furthermore, those UCITS funds which adopt a high water-mark methodology automatically reduce any incentive on the part of the fund manager to take risks in the hope of increasing its own remuneration over the longer term by virtue of the fact that the high water mark requires an absolute improvement in investment performance before the performance fee can be paid, as recognised in the 2016 IOSCO Report[9].

Separately we would note that under the Central Bank rules, any outperformance of a benchmark is subject to a clawback provision under which any subsequent underperformance must be cleared before a performance fee is payable in subsequent periods. IOSCO does not impose this clawback provision on funds which measure their performance against a benchmark under the 2016 IOSCO Report. We would therefore submit that Irish UCITS funds whose performance fee methodology is

[8] Paragraph 1 of Good Practice 3 set down in the 2016 IOSCO Report. Paragraph 3 of the same section sets down the annual crystallisation requirement.

[9] Paragraph 35 of the 2016 IOSCO Report and Annex 3 to the 2004 IOSCO Paper

based on outperformance of a benchmark do not need to be subject to annual crystallisation on the basis that the Irish rules already require the clawback of underperformance in subsequent periods, thus protecting against the risk that the fund manager will be incentivised to take risks in order to increase his/her own fee given that cumulative gains are offset against cumulative losses[10]

Finally we would note that Irish UCITS management companies are now subject to additional regulation relating to remuneration of fund managers by virtue of the obligation under the UCITS Regulations to implement policies that are consistent with and promote sound and effective risk management and do not encourage risk taking that is inconsistent with the risk profiles, rules or instruments of incorporation of the UCITS under management.[11]

(b) ***Crystallisation on redemptions***

As you will be aware, many UCITS funds operate a performance fee methodology under which a performance fee payment is triggered on redemption of shares. We would therefore suggest that if the Central Bank decides to impose an annual crystallisation requirement on all UCITS, Regulation 41(4) be revised to clarify that this rule does not prohibit the crystallisation of performance fees upon a redemption of shares from the relevant UCITS.

Question 4: Stakeholders are requested to indicate whether further requirements are necessitated to better regulate the charging of performance fees by UCITS

As you will be aware, Regulation 41(2)(a) of the proposed Central Bank UCITS Regulations provides that *"no performance fee is accrued or paid until the net asset value per share exceeds:*

(i) *the previous highest net asset value per share on which the performance fee was paid or accrued; or*

(ii) *the initial offer price (if higher). The initial offer price shall be taken as the starting price for this calculation".*

The above reflects the existing Central Bank web-based guidance on performance fees. We would suggest that this wording be revised to reflect the fact that once a performance fee is paid the first time that the net asset value exceeds the initial offer price, the net asset value per share must necessarily always exceed the previous highest net asset value per share on which the performance fee was paid or accrued in order for any performance fee to be payable. This is because the initial offer price cannot be higher than the highest net asset value per share on which a performance fee has already been paid or accrued. We would therefore submit that the wording should be revised in order to remove any ambiguity or confusion caused by the existing wording.

Finally, if, notwithstanding the submissions made to it by industry, the Central Bank proceeds with implementing the draft regulations as currently proposed, further engagement with industry relating to transitional arrangements and requirements relating to updating of fund documentation would be required.

[10] Paragraph 24 of the 2004 IOSCO Paper
[11] Regulation 24A and 24B of the UCITS Regulations