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Exempt Unit Trusts Consultation – CP 68
Markets Policy Division
Central Bank of Ireland
Block D, Iveagh Court
Harcourt Road
Dublin 2

8 October 2013 **Your Ref:** **Our Ref:**
MHC-8641683-1

Dear Sirs,

I refer to Consultation Paper CP 68: "Consultation on types of alternative investment funds under AIFMD and unit trust schemes under the Unit Trusts Act 1990 (including EUTs, REITs etc.)" and attach now for your consideration responses to the questions posed in this document.

These responses have been prepared by us on behalf of, and in conjunction with, our client Independent Trustee Company Limited.

Yours sincerely,

Mark Browne
MASON HAYES & CURRAN

Consultation Paper 68:

Questions and Responses

1. ***Do you believe that our brief summary on the organisation of EUTs as set out above is correct?***

Answer: Yes.

It is worth highlighting that, as noted by the Central Bank itself, EUTs are typically used by pension providers. The activities of pension providers, including in relation to the activities undertaken by EUTs, are already subject to separate regulation by the Pensions Board and the Revenue Commissioners.

2. ***Question: Do you agree with our analysis that an EUT is an AIF?***

Answer: Certain EUTs may constitute AIFs but it is not the case that every EUT will automatically constitute an AIF.

Article 4 (1) of the AIFMD defines AIFs to mean:

> *"collective investment undertakings, including investment compartments thereof, which:*
>
> *(i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and*
>
> *(ii) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC;"*

The "Final Report: Guidelines on key concepts of the AIFMD"[1] (the "Guidelines") was released by ESMA in order to clarify each of the concepts included in this definition because it was recognised that concerns had arisen in relation to the potential for different interpretations to be adopted regarding the constitutive elements of this definition. The aim of the Guidelines therefore is "to ensure more legal certainty" in this regard and the common, uniform and consistent interpretation of this definition across the EU.

The Guidelines provide that an entity should generally not be considered to be an AIF unless all elements included in the above definition are met or are substantially met. Accordingly, where a specific EUT does not meet this requirement then, in accordance with the Guidelines, it is not an AIF.

The key aspects of the definition of an AIF explored in the Guidelines include:

- *"collective investment undertaking";*
- *"raising capital";*
- *"number of investors"; and*
- *"defined investment policy".*

In terms of determining whether an EUT meets the necessary criteria in order to be deemed to constitute an AIF, or to fall outside the scope of the AIFMD, the following would appear to be the key points:

[1] 24/05/13 ESMA 2013/600

(a) **Collective Investment Undertaking**: the requirement *for pooled capital and a pooled return*. The implication is that single investor structures fall outside this. Single investor EUTs with a single target investment would appear even less likely to be capable of being viewed as AIFs.

In that context, it is worth noting that each trust or sub-trust in the EUTs typically used by pension providers are, from both a legal and practical perspective, separate undertakings, involving different and unrelated parties, entirely segregated in terms of their management, objectives, assets and liabilities. In fact, sub-trusts under the most prevalent system used, could in reality be separated into stand-alone trusts in order to ensure that the collective element of an AIF was not met if this was deemed necessary. However it seems counterintuitive that such steps could be effectively required to be taken, thereby undermining a regime which declares itself not to be concerned with legal structure or form and simply incurring additional costs for the underlying pensioner beneficiaries without bringing any benefits.

The ESMA pronouncements on compartments of an undertaking are also important in this regard. Series of an investment undertaking will, whether the individual series consist of multiple investors or a single additional investor, make the overall fund collective in nature. However, sub-trusts of the EUTs commonly used in the pensions industry do not share the characteristics of such series as they are not series of the one undertaking. They are entirely segregated, separate legal structures and bear no common features - other than being under the same overall umbrella for cost efficiency.

(b) **Raising Capital**: 1) *taking direct or indirect steps on behalf of an undertaking or on its behalf.* EUTs are established by an investor by entering into a trust deed with a third party trustee. . Typically in the pensions industry, the EUTs are not established at the instigation of a broker or manager but by the investors. Where the investors approach a trustee entity, as is the norm, it would be difficult to see how this criteria was met.

2) *Structures for capital invested by members of a pre-existing group into an undertaking exclusively established for the purpose of investing their private wealth* may be deemed not to constitute AIFs. Accordingly establishment of dedicated structures for specific groups – e.g. an EUT providing for a pensions scheme investment for employees of an identified employer or clients of a particular investment advisory firm - would appear to meet this criteria.

(c) **Number of Investors**: an undertaking *prevented by national law, its constitutional documents or other legally binding provisions from having more than one investor* (which may not be an AIF itself) will not be deemed to be an AIF. Accordingly including a provision in the trust documents limiting investment or participation to more than one investor should address this and mean that an EUT which adopts a measure limiting its scope to a single investor could not be deemed to constitute an AIF.

(d) **Defined Investment Policy**: the requirement for *a pre-determined investment policy to be followed.* Where the investment policy is fully at the discretion of the investor(s)(not a third party manager) this would appear to avoid this requirement. Many EUTs will not require the appointment of an investment manager on an on-going basis as they will relate to a single set and pre-determined investment.

Summary

In summary, an EUT may constitute an AIF but it will not necessarily do so. It will be necessary to analyse the extent to which an individual EUT meets the criteria of an AIF from a practical perspective in order to determine whether the criteria is satisfied and accordingly whether the EUT is, in fact, an AIF.

All of the features of an AIF, as outlined by ESMA, are important in order to be able to properly distinguish an AIF from other more loosely defined investment structures or legal arrangements, which are mere co-ownerships, special purpose vehicles, joint ventures etc. We contend that it is important that, for example, co-ownerships between like-minded investors, special purpose vehicles between business relations, investment partnerships between spouses and joint ventures between business partners can continue to be formed, on an informal, unregulated basis. In light of the guidance from ESMA these are not AIFs. Equally an EUT does not necessarily constitute an AIF. Since legal form or structure is stated not to have significance in this regard the use of trust law, rather than contract etc. should not alter that assessment.

3. Question: Do you agree that an EUT is subject to the UT Act?

Answer: No.

EUTs have to date been deemed to be exempt from the UT Act on the basis that they were restricted in terms of participation and not available for "public" participation.

The term "public" has been subject to extensive scrutiny by the courts, both in Ireland and internationally in other common law jurisdictions. This has primarily arisen in the context of determining whether a share issuance constituted a "public" offering. The underlying principle from this case law is that an offer to a specific group or sub-section of the public is not a "public offer"[2].

This appears to be the basis upon which the Central Bank has adopted its position with regard to EUTs to date and in the absence of any legislative change requiring a revisiting of this interpretation it would not appear appropriate to seek to arbitrarily overturn established practice in order to seek to force EUTs into the regulated categories from which they have been exempt hitherto.

The specific grounds used to justify the exemption with respect to EUTs generally is, as is recognised in CP 68 itself, on the basis that they are only available to pensions or charities. The volume of investments performed by pensions appears to be a cause for concern and is being advanced as a reason for reconsidering this issue.

"It now seems clear that EUTs cannot be considered excluded from the class of unit trust schemes within the scope of the UT Act just because they are limited to pension fund investors."

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[2] See for example Government Stock and other Securities Investment Co Ltd v Christopher [1956] 1 All ER 490 (Chancery Division) or Corporate Affairs Commission v David James Finance Ltd [1975] 2 NSWLR 710. As an aside it can be noted that the Irish Companies Acts specifically provided for the applicability of the public offer rules to specific groups or sub-section of the public in order to catch this exemption- see for example S 62(2) of the Companies Act 1963.

However, the UT Act has not been amended and the wording of the statute and the inherent requirement for a "public" offer remains. The volume of investment under this category should not be a consideration regarding its interpretation and in the absence of a statutory amendment to the UT Act it would be inappropriate for the Central Bank to unilaterally re-interpret this provision of primary legislation which has been in force over 20 years.

The tax treatment of collective investment schemes ("CIS") for Irish resident investors, and in particular the anti-avoidance provisions relating to Personal Portfolio Investment Undertakings under the Taxes Consolidation Act, mean that a determination that an EUT constitutes a CIS will generally have highly negative tax implications for Irish resident beneficiaries.

4. ***Question: Is there any reason why the Central Bank would not apply the same regulatory regime to EUTs which are AIFs as to any other AIF?***

Answer: Yes

1. The application of AIFMD to EUTs is likely to result in substantially increased costs for pension fund investors. This will arise because of the authorisation requirements applicable to AIFMs and the obligation to appoint independent depositaries. The imposition of such additional costs on existing EUTs will inevitably result in hardship for the beneficiaries of these structures, who are by definition and according to the information provided in CP 68 itself, pensioners and charities.

   An increase in the costs of running occupational pension schemes would seem to be at odds with the statement made by the Pensions Board in its (current) *Consultation paper on the future of defined contribution pensions*, namely that there are too many schemes "where the costs borne by the members are too high and higher than they should be". To introduce further costs into an area which is already extensively regulated (by the Pensions Board and Revenue) seems to serve little purpose.

2. It should be noted that the pensions industry is already extensively regulated and, as observed by the Central Bank itself, EUTs are, by definition, predominantly used by this industry. It is submitted that the application of two separate regulatory regimes would be inappropriate on the basis of being excessive and disproportionate. Accordingly it is submitted that it would be appropriate for the exemption contained in Regulation 3 (3) (b) of the EU (AIFM) Regulations 2013 be interpreted to apply where the investment structures serviced by relevant pension management companies constitute EUTs. i.e. to construe the last line of this exemption to read "in so far as they do not <u>otherwise</u> manage alternative investment funds;"

3. Structures established pursuant to the UT Act are required to be authorised as either RI AIFs or QI AIFs. It is unlikely that investors in EUTs would meet the necessary criteria for QI AIFs but the restrictions applicable to RI AIFs would potentially impose significant additional restrictions on EUTs in terms of their investment parameters etc. Examples of areas where the investment restrictions imposed on RI AIFs would be difficult to reconcile with the regulatory regime for pensions are:

   - The Occupational Pension Schemes (Investment) Regulations 2006 (S.I. 294/2006) sets out rules for investments permissible in occupational pension schemes, to include restrictions on borrowing.

   - The Revenue Commissioners have issued investment rules for occupational pension schemes. The statutory authority for the rules is contained in s.772

(2)(a), TCA97. The rules also apply to EUTs (specifically acknowledged in Chapter 5, Revenue Pensions Manual 2013)

- The Pensions Board has recently issued "Investment Guidelines for trustees of defined contribution pension schemes".

- Where the EUT is used as custodial vehicle for a PRSA (such as is the case for the ITC PRSA), Chapter X of the Pensions Act sets out rules for the governance of PRSA investments.

It will also require such structures to appoint authorised management companies and hence to incur additional expense which was not contemplated when the structures were being put in place and which would appear unlikely to have any benefits for the beneficiaries of the relevant schemes.

4. As already indicated above, EUTs are not always unregulated structures. In some instances, EUTs are regulated in great detail, for example where they are used and approved as the custodial vehicle for pension products regulated by other Irish authorities. As an example, EUTs are used by PRSA custodians as the custodial vehicle for PRSAs, approved and regulated in great detail by the Pensions Board and overseen by a PRSA actuary.

   Similarly, Qualifying Fund Managers regularly use the EUT as a single investor vehicle which allows them to operate Approved Retirement Funds. Such funds are supervised by Revenue under the terms of the Taxes Consolidation Act ("TCA"); if the EUT is deemed a collective investment undertaking, the ARF could fall foul of aspects of the regulations imposed under this legislation, for example the rule in s.784A(1)(b) TCA97 which in practice necessitates the establishment of a single investor custodial vehicle.

While the AIFMD and the UT Act are not, for the reasons specified above, the appropriate means of further regulating EUTs some principles of "good governance" would be welcome:

- Management of EUTs should be confined to investment firms regulated by the Central Bank. The risk management measures adopted by regulated investment firms ultimately raise the governance standards of EUTs, to the benefit of investors. Such a regime works for Qualifying Fund Managers (ARF providers).

- Rules providing for the segregation of the custodial and investment function of the EUT. Experience shows that separation of the investment manager and custodian reduces the operational risk for EUTs (and the potential for fraud).

- Rules similar to the AIFMD principles in relation to charges should be observed.
- Rules akin to the AIFMD principles in relation to valuations must be adhered to.

In terms of implementing such regulations without creating a situation whereby separate potentially conflicting regimes apply, such regulation might best be adopted by amendment of the TCA and then application of a separate and specific regulatory regime in this context.

5. ***Question: What transitional arrangements do you consider should be applied?***

Answer: The maximum or longest possible transitional arrangements should be applied in order to facilitate any necessary compliance for EUTs which find themselves subject to the AIFMD on the basis that they constitute AIFs.

While the argument for a uniform compliance date is noted, it is submitted that a longer lead in is appropriate in this context, if a transition is in fact required, because a determination will only be made as to the status of EUTs several months after the AIFMD was transposed into Irish law. It would be appropriate for such schemes to then be given at least an equivalent lead in time as other AIFs, whose status was clear from the adoption of the AIFMD and its subsequent transposition into Irish law.

It would be inappropriate for pension trustees to incur unnecessary legal costs, which will ultimately be paid by the retirees in their schemes, to engage in unnecessary restructuring. Accordingly, while contingency plans may be adopted prior to the final determination of the position becoming clear, it would appear appropriate for additional time to be afforded where restructuring is required as it would be inappropriate for any costly restructuring activity to have been taken by trustees prior to clarity being achieved in this area.

For the reasons set out at Question 3 above it would not appear appropriate to categorise EUTs as falling under the UT Act and therefore it is unclear at present how EUTs which do constitute AIFs will in fact be regulated by the Central Bank. In view of this it would appear in the best interests of all stakeholders, including the Central Bank as regulator, to adopt a flexible and lengthy transition for affected schemes.
It would also appear of assistance from the Central Bank's perspective to have staggered compliance dates for different categories of entities falling under the AIFMD to slightly reduce the pressure and focus on specific dates such as July 2014. The above paragraph provides a transparent and justifiable reason for making provision for an additional compliance date in this context.