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ARTICLE

Evolution of the Central Bank's Funds Authorisation Process

An examination of the evolution of the Central Bank of Ireland's supervisory approach in respect of new fund applications and post-authorisation amendments.

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Introduction

Recent months have seen an evolution of the Central Bank of Ireland's (the "Central Bank") supervisory approach, resulting in the Central Bank re-focusing its investment fund authorisation resources, applying a risk-based approach. Consequently, industry has observed an increase in (i) robust verification of compliance with requirements and (ii) targeted interventions to tackle key issues and risks the Central Bank has highlighted in specific areas of focus from a regulatory/market perspective as well as from the perspective of safeguarding investor interests (including, unsurprisingly, liquidity and leverage). This represents a timely reminder of first principles for asset managers seeking authorisation of Irish regulated funds. This article briefly recaps some of the main areas of focus for the Central Bank, which require consideration by both fund sponsors and fund boards prior to launching a new fund.

Background

In March 2020 (in the context of UCITS) and June 2020 (in the context of QIAIFs) the Central Bank held industry seminars relating to investment fund authorisations (the "Seminars"). At each Seminar, the Central Bank reminded industry participants of its supervisory role and its mandate to protect shareholders. The Central Bank also highlighted certain fund characteristics that are likely to attract additional attention or enhanced scrutiny during the fund application process, these include:

a) Provision for unusually high leverage;

b) Liquidity profile of the fund not being aligned with its portfolio constituents;

c) The presence within the fund structure of non-discretionary investment advisers appearing to act with discretion;

d) In the context of UCITS, securities subject to media attention, regulatory scrutiny or commentary at a European level such as CLOs, leveraged loans, CoCos, CFDs etc.; and

e) Quality and clarity of investment policy disclosure.

Enhanced scrutiny, as the Central Bank pointed out, is not new, but is more of a new iteration and practical implementation of the Central Bank's established principles of authorisation and supervision.

Considerations Prior to a Fund Launch

The Role of the Fund Board

The Central Bank was also keen to reiterate the front line responsibility of the investment fund's board (the "Board") in the application process.

The Board must be able to demonstrate to the Central Bank, based on documented evidence, that it has fully considered and properly documented all key aspects of the structure of the proposed fund prior to it making an application for authorisation to the Central Bank if the proposed fund is a type that merits *enhanced scrutiny*. Accordingly, a Board meeting should be convened prior to the application being submitted to the Central Bank. At that meeting the Board shall discuss all aspects of the application, including but not limited to (i) the quality of disclosure in the prospectus and/or supplement; (ii) the proposed investments of the fund; (iii) the use and effect of leverage (if any); (iv) liquidity analysis and liquidity stress testing; (v) a consideration of the risks associated with the investment strategy and (vi) due diligence on service providers to be appointed to the fund (the Central Bank added that reliance on questionnaires alone is not sufficient, there should also be appropriate in depth analysis).

Furthermore, the Board must be satisfied that in the case of a proposed UCITS it is suitable for retail investors, which is of paramount importance for all UCITS fund applications given the primacy of the Central Bank's mandate to protect shareholders.

Liquidity

The Central Bank stressed that funds investing in securities that are listed or traded on a regulated market does not automatically mean that securities are sufficiently liquid. Consequently, due diligence on liquidity should cover items such as the average trade volume and trade size of assets, ensure that transparent pricing and post-trade information is available and whether asset classes have a proven record of price stability.

Model Portfolios

The Central Bank may also require a completed model portfolio as part of its *enhanced scrutiny* review. The model portfolio should allow the Central Bank to ascertain:

a) That the portfolio reflects what has been provided for in the offering documentation and that investors therefore have a clear understanding of the fund and its strategy

b) That any benchmark being proposed for the fund is appropriate;

c) The liquidity profile of the fund;

d) The creditworthiness of the fund;

e) The appropriateness of the risk factors; and

f) Any strategy divergence over time.

While understanding that it may not be possible to list the exact securities that the fund intends to hold, the Central Bank expects that it would be possible to provide an indicative list which will align approximately with the fund's future holdings. The Central Bank may use this information at a future date to assess alignment of the fund's portfolio, as well as the fund's use of leverage, with the corresponding disclosure included in the fund's prospectus/supplement.

QIAIF Specific Considerations

The Central Bank reiterated to industry that the QIAIF 24-hour fast track approval process remains unchanged and that QIAIFs are not subject to many investment or borrowing restrictions. The popularity and success of the QIAIF was also highlighted by noting that, at the date of the Seminar, 2,637 currently active QIAIFs had been authorised since 2007, representing approximately 50% of all funds authorised in that period. As such, the Central Bank noted that ensuring the integrity of the regime is crucial to its continued operation.

With the foregoing in mind, the Central Bank indicated that where a proposed QIAIF (i) intends to hold uncommon asset types; or (ii) has unusual features, a pre-submission should be sent to the Central Bank. Examples of funds with unusual features cited by the Central Bank included funds with high levels of leverage, property funds, life settlement funds and loan originating funds. The pre-submission should provide an overview of the proposed QIAIF as well as its proposed liquidity. A model portfolio may be required in certain circumstances (generally those QIAIFs with unusual features).

In the context of what might be deemed high leverage, the Central Bank reiterated that it did not set any leverage limits or other restrictions on the use of leverage by a QIAIF, but nonetheless the leverage limit set by the AIFM must be realistic and clearly relatable to the QIAIF's strategy. The proposed utilisation of leverage should be disclosed in such a manner to provide investors a good understanding of how and why leverage is used, as well as its extent.

Conclusion

The evolution of the Central Bank's application process, including the *enhanced scrutiny* regime represents a welcome development to the fund authorisation process. It should ensure standards of compliance and the quality of disclosure in Irish regulated fund products are all maintained and improved. Fundamentally, this enhances investor protection and ensures the stability of the industry, which is of paramount importance to all industry stakeholders.

The Seminars were also a timely reminder for fund boards on the Central Bank's expectations of the role and obligations of Boards, which helps to continue to ensure best practice from a governance perspective.

Fund sponsors and Boards should take comfort from the fact that provided they can collectively demonstrate to the Central Bank that they have undertaken appropriate due diligence and given due consideration to the letter and spirit of our regulatory regime, funds may continue to be launched in a fair and transparent manner.

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