

Central Bank of Ireland Approval Process for UCITS Side-Pocketing Arrangements

On 16 May 2022, the Central Bank of Ireland ("Central Bank") published a Notice of Intention¹ on its approval process for Irish UCITS side-pocketing arrangements in relation to Russian, Belarusian and Ukrainian assets which have been impacted by Russia's invasion of Ukraine and / or by sanctions imposed as a result of the invasion ("Notice").

ESMA Statement

The Notice followed an earlier ESMA statement² on the implications of Russia's invasion of Ukraine on investment fund portfolios ("Statement") issued on the same date.

Notwithstanding that the UCITS framework does not make reference to side pockets, ESMA, in consultation with the European Commission, paved the way for the Central Bank by stating that for the purpose of managing the impact of the Russian invasion of Ukraine on the portfolio of a UCITS fund, side pockets could be permissible where the liquid and illiquid assets are segregated by way of transferring the liquid assets to a new UCITS or a new sub-fund of the original UCITS.

Following this segregation, existing investors would receive shares in the new UCITS / sub-fund in the same proportion as their investment in the initial UCITS, whereas new investors

would only subscribe to the new UCITS / sub-fund holding the liquid assets.

Such an arrangement must be in the best interests of investors and cannot result in the transformation of the UCITS to a non-UCITS. General conduct of business rules and disclosure requirements set out in the UCITS Directive require that investors and home national competent authorities must be informed in a timely, clear and comprehensive manner of the envisaged use of side pockets. Investors should also be informed on a regular basis both of the illiquid and liquid parts of the original UCITS portfolio.

Comprehensive Analysis

In the Statement, ESMA calls for a comprehensive analysis by the UCITS manager to ascertain whether and which of the permissible side-pocket arrangements could be implemented in the relevant case and under what circumstances and conditions. The advantages and disadvantages for all investors wishing to subscribe, redeem or remain invested in the fund need to be carefully weighed up.

Regard should also be had to the UCITS risk diversification requirements. The risk profile and constitutional documents of the UCITS should also be reviewed and changed if necessary,

¹ <https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/notice-of-intention-ucits-side-pocket-arrangements.pdf>

² https://www.esma.europa.eu/sites/default/files/library/esma34-45-1633_public_statement_on_impact_of_war_in_ukraine_on_investment_funds.pdf

with such changes reflected in an updated prospectus if necessary.

Regulatory requirements including restrictions linked to the evolving sanctions regime and potential adverse implications under the applicable national rules should be considered.

Special consideration should be given to the legal effects and contagion risk of any segregation method used under the applicable rules, noting that there is no legal segregation of assets between different UCITS share classes and that in some Member States, the legal segregation of assets between sub-funds is uncertain, which could create risk of future liability arising in one sub-fund of a UCITS impacting the assets and investors in other sub-funds.

Central Bank Approach - Side Pocket by Way of New UCITS

The Notice clarifies that subject to the requirements set out below, the Central Bank will permit an Irish UCITS to implement a side-pocket arrangement only for Russian, Belarusian and Ukrainian assets that are directly and / or indirectly impacted by the Russian invasion into Ukraine and / or impacted by sanctions imposed as a result of that invasion ("Affected Securities").

In contrast to ESMA which describes the scenario outlined in the Statement as non-exhaustive and which does not exclude that other side-pocket arrangements may be permissible, the Central Bank definitively states that the side-pocketing of Irish UCITS assets is only available in the context of Affected Securities and should not be interpreted as creating a precedent by the Central Bank for any other current or future situations.

The Central Bank will permit a side-pocket arrangement by way of a clone fund into which liquid assets of an original UCITS may be transferred into a newly authorised / approved clone UCITS.

Shareholders in the newly established clone UCITS will hold shares in that fund pro-rata to their holdings in the original UCITS. Investors in the original UCITS will continue to have a pro-rata holding in the original UCITS. The original UCITS should be wound down over time with any realised value paid out to shareholders.

Central Bank Requirements

A side pocket may be established by way of a newly established clone UCITS provided that:

- the proposal is in the best interests of shareholders;
- shareholders approve of the transfer into the newly established clone UCITS side pocket;
- the proposal has received prior written approval of the Central Bank;
- shareholders are provided with a clear description of the costs and fees associated with establishing the side pocket. Details of ongoing costs and fees payable must also be provided in the UCITS prospectus;
- the original UCITS is placed in wind-down mode at the same time as the creation of the clone UCITS;
- written policies in relation to the management of the Affected Securities are put in place by the original UCITS, including policies relating to the costs and fees associated with maintenance of the original UCITS; and
- the original UCITS reports to the Central Bank on an annual basis confirming whether or not the parameters and policies continue to be respected and outlining the prospects and / or plans for the side-pocketed assets and liquidation of the original UCITS.

Streamlined Process

The Central Bank has introduced a streamlined authorisation / approval process to facilitate the orderly implementation of such side-pocketing arrangements. Specifically, an application for authorisation / approval of a new fund / sub-fund should be made in the normal manner and accompanied by:

- confirmation from the directors of the fund that the new fund / sub-fund is identical to the original UCITS;
- a copy of the resolution approving the establishment of the new fund / sub-fund; and
- a mark up of the investment objective and policy against that of the original UCITS.

Applications which meet these criteria will be processed within five working days. Advance notice of such applications should be made to fundsauthorisation@centralbank.ie and onlineauthorisation@centralbank.ie.

How can Maples help?

Our Funds & Investment Management Group are working with clients on a full range of advisory matters connected with the Russian invasion into Ukraine and related EU restrictive measures. This includes assisting with the review of existing fund documents, drafting policies in relation to the management of Affected Securities, the preparation of applications for authorisation / approval of new funds / sub-funds and the winding down of original UCITS as appropriate.

Further Information

For further information, please liaise with your usual Maples Group contact or any of the persons listed below.

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The Maples Group's Irish legal services team is independently ranked first among legal service providers in Ireland in terms of total number of funds advised (based on the most recent Monterey Insight Ireland Fund Report, as at 30 June 2021).

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