MATHESON ORMSBY PRENTICE

SUBMISSION TO THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS ("CESR"): CONSULTATION ON RISK MANAGEMENT PRINCIPLES FOR UCITS

Matheson Ormsby Prentice is one of the largest law firms in Ireland. It has a large banking and financial services practice serving both domestic and international financial institutions and it has a prominent asset management practice that serves the international mutual funds industry based in Ireland. In this context, we welcome the opportunity to make a submission to CESR in response to its consultation on Risk Management Principles for UCITS.

We set out our comments below in the format of answers to questions raised in the consultation.

Box 1: Supervision by competent authorities

We do not fully agree with the proposal in box 1 that the adequacy and efficiency of the risk management process should be considered by the competent authorities as part of the process for licensing the UCITS/Company, and subsequently monitored on an ongoing basis. Our concern is that CESR should employ a principles based approach to regulation rather than a prescriptive approach, and that the board of directors of each UCITS should be allowed to determine the appropriate level of control necessary to implement the general principles outlined, particularly in light of the enormous variety of product within the UCITS regime, and especially since the enactment of UCITS III. We would also submit that CESR should not recommend a process that would prejudice those UCITS who appoint third party investment managers many of whom are from third countries, the USA, Hong Kong, Japan and so on.

We would point out that Article 5f(1)(a) of the UCITS Directive establishes the existing obligation to have adequate procedures and internal control mechanisms. To the extent that the Directive provides more detail in respect of this requirement, it does so in Article 21 which focuses on the risks associated with positions in derivatives. We suggest that the main high level recommendations produced by CESR should focus on risks associated with derivatives only and should not extend, in such detail, to every other risk which the UCITS could face. Risks should not be ignored, but any approach recommended by CESR should be consistent with the Directive and should thereby only reflect a requirement for very specific detail in respect of risks associated with positions in derivatives, with flexibility to accommodate different operating models of UCITS.

Box 2: Definition of roles and responsibilities

We would request that CESR incorporates recognition that where service providers are appointed by the board following due process and consideration, the board should be able to rely on the service provider's contractual assurances as to its processes. A typical UCITS in Ireland will have an Irish-based administrator and custodian and will have an investment manager based in either the EU or a third country. An investment manager will have processes and procedures to deal with market and other investment related risks, similarly the administrator will have its processes and procedures in place to mitigate its risks. The existence of and the ability to rely upon these structures ought to be recognised by CESR in the context of the current proposals. In support of this we would point out that fund administrators in Ireland are regulated by the Financial Regulator and any investment manager of an Irish UCITS must be approved by the Financial Regulator. All investment managers must also be regulated and indeed they must be regulated to a standard that that Financial Regulator is satisfied is equivalent to Irish standards. We do accept that the board will have the responsibility to supervise any delegate but this has already been dealt with in the implementation of the Management Company

Directive where detailed governance arrangements have been put in place for both UCITS III managers and self-managed UCITS III funds. The only overlap between these requirements and those of the Management Company Directive should that these should provide more detail in respect of risks related to a UCITS holding derivative positions.

In this regard, we submit that the requirement to identify specific personnel and units from the fund company that are directly "in charge" of different parts of the risk process is too prescriptive, and does not take into account the delegation structure referred to above.

With respect to the reference to keeping the UCITS risk profile under control and consistent with the UCITS investment strategy, we would welcome clarification as to what is meant by the concept of risk profile in the context of these proposals. It seems to suggest that some sort of self-categorisation as high, medium or low risk is needed and some sort of constant assessment against that categorisation is made. The key parameter for investment risk is and ought to continue to be the prospectus and the investment manager should report to the board regularly on its adherence to the investment objectives and policies in the prospectus.

Box 3: The risk management function

We refer to our reply to Box 2 above. The suggestions in this box are too rigid and need to be able to reflect the fact that Irish UCITS will likely use a third party investment manager. We would ask that CESR recognise that a UCITS may have regard to the risk management processes established within its service providers' functionality and service offering for the purposes of appropriate risk management.

The language at Box 3.2 is almost identical to that in the MiFID Directive and is not in the UCITS Directive. Where a UCITS uses service providers, it will not in itself have a risk management function - rather the board of directors will be responsible for ensuring that appropriate service providers are appointed and to receive and monitor appropriate reports from those service providers to whom the mandate is given, but that subject to this, the board of directors ought to be able to rely on processes and procedures of that service provider.

Paragraph 12 refers to reporting to the board which would enable the board to "assess the adequacy of the measures adopted to manage risks". In an Irish UCITS, as mentioned above, the board of the fund will appoint what it will determine are appropriately qualified service providers (who will be regulated as set out above). Those service providers will be best placed to know the risks of their particular business whether that is transfer agency, investment administration or an investment manager. It is not credible or logical to expect businesses to report to the board of a UCITS in respect of which they provide services with regard to the risks within their own business as they specifically apply to that UCITS. It ought to be sufficient for the service provider to report to the board of the UCITS how they measure, manage and monitor their risks and to thereby gain an assurance that that risk is addressed. However, to ask the board of directors of a UCITS to "assess the adequacy" of such measures is not reasonable.

This recommendation could add that where service providers are used, the due diligence process prior to the appointment of such service provider should examine risk management at that service provider. In this regard paragraph 14 is not clear enough and should not be qualified by the insertion of the words "where it is not appropriate or practical".

In terms of points 8 -12, we note that in large part these reflect the provisions of MiFID. Where investment managers are located in the EU/EEA, all of these provisions will already be in place within the investment manager and with respect to third country investment mangers, they will all be regulated, with all major regulators generally having broadly similar requirements. We believe that the board of directors ought to be able to rely on the structures within its service providers and this CESR recommendation should not dictate how those structures are organised.

Box 4: Outsourcing

In the context of the Irish UCITS industry, we strongly disagree with the recommendations in this section. As outlined above, while the board of directors will always have overall responsibility for all

aspects of a UCITS, the board ought to be able to rely on duly appointed and, where relevant, appropriately regulated service providers to deal with the risks within their areas of expertise. We agree that there must be relevant reporting to the board, but that the board of the UCITS ought to be able to determine the level of reporting that it deems adequate in the circumstances of the particular UCITS.

We disagree that risk management is a single function that, as a separate function, can be outsourced in the manner described. Again, the language of the recommendation mirrors that in MiFID but in our view it misunderstands the arrangements. Where an Irish UCITS appoints a transfer agent, it is not outsourcing that service rather it is purchasing the relevant expertise from a competitive marketplace. Where an Irish UCITS appoints a company to provide investment administration services, it is purchasing the expertise to calculate the daily NAV and produce accounts and, again, when an Irish UCITS appoints an investment manager it is appointing an expert from a highly competitive marketplace to manage the portfolio in accordance with the prospectus. None of these services are capable of being carried out by the board of the UCITS, and in this sense the relevant industry expertise is "hired in" as opposed to being activity which the UCITS does that is outsourced. Fundamentally, we believe that these requirements are appropriate for entities such as investment managers (which would be covered by MiFID or other regulatory regime) but not for UCITS themselves unless the UCITS has management and staff, including investment professionals and administration staff, to perform transfer agency and other administrative services to the UCITS.

Box 5: Identification of risks relevant to the UCITS

As set out above, we believe that the recommendations should focus on risks associated with positions in derivatives. These and the other trading type risks are more appropriately identified and managed by the investment manager of a UCITS not the board of the UCITS itself. To re-iterate the points made above, the board ought to be entitled to rely on the risk processes in any investment manager it appoints subject to an adequate due diligence process and to adequate ongoing reporting, with adequacy in each case being assessed by the board of directors.

Again, we note that the recommendation refers to a "risk profile", and we would ask that clarification of what is meant by this term in the context is addressed. We are not aware of any industry standard benchmark by which a profile can be measured or assessed. We are of the view that the level of knowledge which these requirements impose on boards of directors is unrealistic and unnecessary.

Box 6: Risk Measurement Techniques

We would make the same comments as with respect to box 5 above. The requirements as to the measurement of investment strategies and management styles is something that should exclusively be the remit of the investment manager of a UCITS. This recommendation should specifically recognise that such risks are primarily managed by the investment manager and ought to be supervised by the board of the UCITS. This recommendation is too prescriptive - for example paragraphs 27 and 28 are very specific. As outlined above, a more principles based approach is appropriate. It should be a principle that the more complicated a UCITS or the investment strategy of a UCITS is, the more sophisticated the risk management process should be, but such specifics are best left to the individual investment manager. We would re-iterate that in every case for an Irish UCITS, the investment manger will be regulated to a standard that is equivalent to EU standards.

Again, we would emphasise that these recommendations need to focus on risks arising from positions in derivatives as required by Article 21 of the Directive.

Box 7: Management of model risk concerning the risk measurement framework

We believe that these recommendations make sense, but only in the context of risks associated with derivative positions or portfolio positions and we suggest that these recommendations be clarified in this respect.

The valuation of securities will be covered by the prospectus and therefore this recommendation should link to the prospectus to make sure there can be no inconsistency.

As above, the recommendation should make it clear that the investment manager would undertake these responsibilities on a day-to-day basis, subject to appropriate reporting to the board on a regular basis.

Box 9: Risk Management Procedures

With respect to the recommendation that the board of directors should formulate the "risk profile" for a UCITS, sufficient specificity regarding the meaning of this term has not been addressed in the consultation paper. We believe the board of directors should seek to understand what are the key risks of the UCITS, disclose these in the prospectus, and ensure that appropriate mitigating measures are put in place but the use of the phrase "risk profile" will we believe cause confusion for boards and for investors.

Box 10: Risk Limits System

This only makes sense, we would submit, in the context of risks associated with the use of derivatives. Hard limits in respect of investments generally are set out in the Directive and will be prescribed by the prospectus. We believe it ought to be for the board of directors to devise the appropriate system of reporting it deems necessary, having regard to the nature of the fund and the service providers to the UCITS. We believe that a more principles based approach, where adequate reporting must be in place, should be the over-arching requirement.

Box 11: Effectiveness of the risk management process

We agree that there should be a control mechanism if hard limits are breached. We believe that only material breaches should be notified to the board of directors immediately with non-material breaches reported at the next formal board meeting. We suggest too that such reporting is only practical in the case of hard quantitative limits in respect of investment rules and the use of derivatives.

Box 12: Reporting to the Board of Directors and the Senior Management

As outlined above, we believe CESR should adopt a principles based approach and these recommendations, for example the reference to "in-depth analysis", should be replaced with a requirement for the board to determine a detailed but proportionate reporting mechanism. Our concern is that the board of the UCITS ought not to be required to second guess the expertise of the investment manager. We suggest that this section specifically recognises that a UCITS may use service providers to provide services to the UCITS, and that the board ought to agree an appropriate reporting mechanism with such service providers.

Box 13: Monitoring of the risk management process

This language is similar to MiFID and implies that a UCITS must have an internal audit type function. We think that these recommendations do not take into account the model in Ireland and in other Member States where services are provided by third parties which are often located in third countries. A board of a UCITS ought to be able to seek an assurance as to the risk processes at a service provider but should not have to go so far as to conduct an internal audit. Third party firms will usually conduct internal audits, but the results will be considered confidential to that service provider. We think that this recommendation should allow the board of directors of a UCITS to seek comfort from its service providers that they have adequate systems as appropriate, for example a SAS70 certification might be sufficient in many cases.

Concluding comments

Overall, we would respectfully suggest that the proposed recommendations do not generally take into account the structure of the investment fund industry in Ireland where a UCITS will appoint third party service providers to undertake key activities of the UCITS. These service providers will be regulated (whether in Ireland or the EU/EEA or elsewhere), and to a standard that is acceptable to the Financial Regulator. Taking a principles based approach, the board of directors itself is the appropriate organ to decide how, on a case by case basis, it approaches each such service provider, and how such service

providers can satisfy the board that it has adequate processes and procedures to measure, manage and monitor risk in the UCITS in the best interests of the fund and its shareholders.

As outlined in the main body of our responses above, we submit that this consultation should focus on recommendations related mainly to positions in derivatives, as required by Article 21 of the Directive. The management of other risks has been covered as part of the implementation of the Management Company Directive, and unless there is a clear demarcation between the two there will be duplication and confusion.

We believe that the way the Irish Financial Regulator has implemented the risk requirements of the Directive and the Management Company Directive are very robust. Following lengthy consultation with industry, clear guidance notes have been published that are widely understood. We do not believe that any material changes are necessary to the measures which the Irish Financial Regulator currently has in place.

For further information in relation to this client update, please contact Joe Beashel at the details below. Full details of the Asset Management and Investment Funds Group, together with further updates and briefing notes can be accessed at www.mop.ie

Matheson Ormsby Prentice
70, Sir John Rogerson's Quay, Dublin 2
T: +353 1 232 2000
F: +353 1 232 3333
E: joe.beashel@mop.ie