



Ref: CESR/09-100

**CESR's consultation on the risk management  
principles for UCITS**

**Feedback Statement**

**FEBRUARY 2009**

## INTRODUCTION

1. The European legislation in the field of collective portfolio management is rather limited as regards risk management. Article 5f(1)(a) of the UCITS Directive establishes the obligation for the home Member State to require asset management companies to have adequate procedures and internal control mechanisms in place. More detailed provisions are set out in Article 21 of the Directive, which focuses on principles for the measurement and management of risks associated with the positions in derivatives. In 2004 the European Commission issued a Recommendation<sup>1</sup> to supplement the above provisions on the use of financial derivatives by UCITS. The Recommendation, however, stresses the general principle according to which “all material risks” incurred by the UCITS should be accurately measured.
2. CESR, through its Investment Management Expert Group<sup>2</sup>, carried out a survey on how the 2004 Recommendation had been implemented in the different EU jurisdictions. The survey was also aimed at assessing whether CESR Members require risk management systems for all UCITS, including those not investing in derivatives. 25 Members responded to the survey. The responses highlighted different approaches to risk management as well as to the implementation of the 2004 Recommendation.
3. CESR’s view is that sound risk management systems require organisational requirements and specific safeguards and diligences in order to ensure that all kinds of risk are adequately captured. Convergence work in the area of risk management would be helpful in preventing regulatory arbitrage, fostering mutual confidence and delivering investor protection.
4. On August 19, 2008 CESR published a consultation paper on the risk management principles for UCITS. The consultation closed on October 17, 2008. 18 responses to the consultation were received and are available on CESR’s website. Most of the responses came from the asset management sector. The other respondents were a banking association, consultancy firms and a general professional association. A full list of respondents is included at Annex 1; the responses themselves are available on CESR’s website under the heading ‘Consultations’ at [www.cesr.eu](http://www.cesr.eu).
5. This feedback statement provides a summary of the main comments received by CESR along with an explanation of CESR’s preferred approach on some of the most significant issues raised. The feedback statement follows the structure of the proposed principles and covers the following main areas:
  - the governance and organisation of the risk management process, in particular the modalities for identifying roles and responsibilities in the risk management process, clarifications on independence requirements, and conditions for outsourcing;
  - the identification and measurement of risks relevant to the UCITS, with a particular focus on the scope of risks to be managed and on how the requirement to use appropriate risk management tools should be understood;

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<sup>1</sup> Recommendation 2004/383/EC of 27 April 2004.

<sup>2</sup> The CESR Investment management Expert Group is chaired by Lamberto Cardia, Chairman of the Italian Commissione Nazionale per la società e la borsa (CONSOB).



- the management of risks relevant to the UCITS, in particular clarifications on specific testing methods such as back testing and stress tests and how those may interact with the valuation process;
  - reporting and monitoring.
6. A first section will deal with general comments, some of them are relevant to several parts of the CESR principles.

## GENERAL COMMENTS

7. Respondents welcomed CESR's initiative to propose some harmonisation in the risk management area as this function plays a crucial role in the protection of investors but also in the fulfilment of their duties by UCITS' managers.
8. A significant number of respondents expressed a broad support for the principles proposed in the CESR's consultation paper. However, some general comments were raised on the definition of the scope of the paper, the principle of proportionality, the need to adopt a principles-based approach and avoid an unlevelled playing field between substitute investment products as indicated below.
  - Risks to be covered by the risk management process
    9. CESR believes that, in line with the European Recommendation mentioned above, the risk management process should assess and address all risks relevant to the UCITS. The proposal was supported by the vast majority of respondents. Only few stakeholders considered that the principles should focus only on risks associated with derivatives or other structured products with exposure to underlying counterparty, liquidity and credit risk.
    10. Some respondents argued that the risk management process should only cover "material risks" or "material and predictable risks", while another expressly mentioned that also "non-material risks" should be identified in order to be able to monitor if and when they may become material for the UCITS. CESR harmonised the notion of risks throughout the document so as to make clear that only risks that are identified as being relevant to the managed UCITS should be covered by the risk management process. The reference to "materiality" which was initially contained in the paper was kept. In particular, CESR recommends that the risk management process should regard as relevant the "material risks" which can be expected, with reasonable level of confidence, to directly affect the interests of unit-holders
    11. A small number of stakeholders considered that relevant risks to be regarded by the risk management process should not include those related to "the trading style adopted by the managers". One respondent suggested that a non-exhaustive list of "relevant risks" would be a useful guidance. In that respect, CESR notes that the consultation paper already listed a number of areas where material risks may be identified. This includes "the trading style adopted by the manager" as CESR believes it can constitute an important source of risks.
  - Proportionality
    12. The consultation paper was referring to a principle of proportionality in Box 2.1<sup>3</sup> and in

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<sup>3</sup> "In order to fulfil the duty to identify, measure and manage the risks relevant to the UCITS, Companies should structure, operate and maintain an adequate and proportionate risk management process, whose functioning and organisational rules should be established as part of the organisational rules adopted by each Company" (Box 2.1).

Box 3.2<sup>4</sup>. Some respondents argued that this principle should be expanded or enshrined at the beginning of the paper. In particular, it was asked this principle to be emphasised in boxes no. 2 (Definition of roles and responsibilities), no. 3 (The risk management function) and no. 6 (Risk measurement techniques). CESR agrees that the principle of proportionality is essential so as to allow UCITS/management companies to effectively manage risks without too burdensome and costly requirements. This principle was reinforced throughout the paper and added to relevant boxes.

- Principles-based approach

13. While there was a broad support to CESR's approach, a small number of respondents raised concerns about the level of prescription of the proposed principles and invited CESR to adopt a more principles-based approach to regulation. CESR believes that the proposed approach is already a principle-based one and confirms that a minimum level of prescription is necessary so as to ensure that harmonised and appropriate risk management standards are in place throughout Europe.

14. Two stakeholders felt that the proposed principles might not be applicable to their national business model where investment functions are delegated to a third party investment manager (regulated and approved by the competent authority) and where the delegating UCITS/management company relies on the risk management process established within the delegated service provider. CESR is of the view that, in order to ensure an effective and independent risk management process, a UCITS/management company has to retain sufficient means and should not rely entirely on the delegatee.

- Level playing field

15. Few respondents expressed concerns about the impact of the proposed principles in terms of costs for the asset management industry and outlined the need to avoid an unlevelled playing field between substitute investment products offered to retail investors. CESR understands these concerns but it is aware that it is nevertheless crucial for investor protection to identify a minimum level of requirements for an effective and independent risk management process. The principle of proportionality would allow mitigating costs for small and medium-size management companies and less complex UCITS. Moreover, CESR points out that the relevant provisions of the MiFID Level 1 and 2 Directives have been taken into account and is hopeful that the proposed principles may serve as a basis to define the risk management regulatory framework in relation to other substitute investment products offered to retail investors.

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<sup>4</sup> "The risk management function should be hierarchically and functionally independent from the operating units, where appropriate and proportionate in view of the nature, scale and complexity of the Company's business and of the UCITS it manages" (Box 3.2).

## DEFINITIONS

16. Some respondents proposed to introduce a definition for “Board of Directors” in order to clarify that this covers the board of the designated management company or the board of the self-managed UCITS, but does not cover the board of the UCITS where the UCITS is managed by a management company. The proposal has been taken into account.
17. It was suggested that the term “Outsourcer” should be changed into “Outsourcee”. CESR paper was amended accordingly.
18. One respondent considered that a common definition of “risk management process” should be introduced. CESR does not deem this necessary as there are enough elements in the text that clarify what the process aimed at managing risks should cover.
19. One respondent argued that there should be a definition for “market risk”. CESR notes that some guidance regarding the typical meaning of “market risk” was already provided in the consultation paper in the section headed “Risk relevant to the UCITS”. In any case, CESR is of the view that defining all or certain categories of risks would go beyond the scope of this present work. It is rather for UCITS/management companies to identify which risks may arise from markets based on their skills and experience.

## LEVEL 3 MEASURES

### PART 1 – SUPERVISION

#### Box 1 – Supervision by Competent Authorities

20. Some respondents stressed the importance that a consistent approach be adopted by competent authorities regarding the assessment and on-going monitoring of risk management process. CESR is aware that the adoption of a consistent approach is necessary in order to allow one risk management process be used in multiple jurisdictions and minimise costs to firms. Clarifications on the purpose of the assessment and on-going supervision by competent authorities have been added to the explanatory text. The regulatory work that will be conducted by CESR within the context of the forthcoming UCITS IV Directive will foster further harmonisation of the supervisory practices in the area of risk management.
21. A slight majority of respondents argued against the re-assessment of the risk management process when a new UCITS is authorised, as this would be burdensome and would slowdown the licensing procedure. CESR considers that, for the purposes of investor protection, it is crucial that supervisory authorities play an active role in assessing the adequacy of the risk management framework. In particular, CESR is of view that, when licensing new UCITS, competent authorities should assess whether the risk management process remains adequate and effective having regard to the characteristics and degree of complexity of the new fund which is sought to be managed. CESR has nonetheless clarified in the explanatory text that competent authorities can take into account their previous appraisals of the risk management process.
22. Some stakeholders expressed the view that only “material” changes to the risk management process should be notified to competent authorities. CESR has taken account of this view. The revised explanatory text states that the risk management process should be supervised by competent authorities on an on-going basis, and only “material” changes should be notified to competent authorities. Moreover, CESR has clarified that the purpose of the notification is to ensure that the competent authorities have the opportunity to intervene in appropriate cases.

### PART 2 – GOVERNANCE AND ORGANISATION OF THE RISK MANAGEMENT PROCESS

#### Box 2 – Definition of roles and responsibilities

23. Respondents to the consultation broadly agreed with the proposed roles and responsibilities.
24. In line with general comments, some stakeholders felt that the “proportionality” principle should be stressed. As noted above, CESR supports this view. The revised Box 2.1 states that the risk management process should be proportionate to the nature, scale and complexity of the management company’s activities and of the UCITS it manages.
25. Some respondents were of the opinion that a separate “risk management policy” is not necessary. CESR introduced some flexibility on the formalisation of such a policy. The

explanatory text clarifies that the risk management policy should ideally be a separate document but could also, in light of the principle of proportionality, be documented within the existing organisational and procedural rules. Whatever the format, CESR confirms that the documents should allow for a clear distinction of the risk management roles and responsibilities and operating procedures.

26. In the consultation paper, it was stated that the risk management policy should specifically identify the personnel and unit(s) that are in charge of the different parts of the risk management process. One respondent took the view that this requirement may be too prescriptive. CESR considers it is crucial for any UCITS/management companies to have a clear risk management policy in place. This will also allow the competent authority to conduct effective supervision in this area. It has however been clarified in the explanatory text of Box 3 that it would be sufficient to identify the personnel in terms of the number of persons and their roles.

### **Box 3 – The risk management function**

27. A number of respondents expressed broad support to CESR proposal. Few stakeholders commented on the requirement to have a “separate” risk management function, its interaction with the portfolio manager and the frequency of appraisals as detailed below.
28. Most respondents supported that the risk management function should be independent from operating units where appropriate and proportionate with the activities of the UCITS/Management company. One respondent invited CESR to amend paragraph 13 of the consultation paper<sup>5</sup> to require a “complete separation” from the front-office functions. This proposal was taken into account.  
Further clarity was foreseen by some stakeholders regarding the conditions under which it is acceptable not to have a “separate” risk management function. CESR is of the view that a separate risk management function serves the purposes to achieve an appropriate level of independence. However, CESR recognizes that it is necessary to allow flexibility in structuring the risk management framework. The explanatory text indicates that such flexibility may concern small companies for which it could be disproportionate to establish a separate risk management function.
29. It was also outlined in the responses to the consultation that the risk management function should be adequately funded and that the relevant remuneration should be independent from the performance of the UCITS. Those comments were taken into account.
30. Some respondents pointed out that a clear distinction should be made between the functions which are the responsibility of the investment manager and those to be carried out by the risk management function. Also, whilst strongly supporting the principle of independence, another respondent drew out from its experience that “best practice” risk management process has always involved a high level of interaction between the portfolio managers and the risk management team. CESR fully agrees with the comments made above and introduced a clarification on the respective roles of the portfolio manager and the risk management function, the former being responsible for taking investment decisions compatible with risk limits and the latter being in charge of measuring risks and monitoring the risk limit system. The need for close interaction between the two functions is also emphasised.

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<sup>5</sup> Paragraph 13 provided that “For the risk management function to operate successfully, a degree of separation from the Company’s front-office functions is required”.



31. In the consultation paper (paragraph 15), CESR required an ongoing, dynamic risk management process, for which an appraisal only at intervals will not be sufficient. Some stakeholders argued that the frequency of the appraisal should be left to the discretion of the management company. Imposing more frequent appraisal could prevent timely investment in the best interest of investors. CESR believes that the appraisal of risks should be made on an on-going basis, but agrees that it should not prevent timely investments. The revised explanatory text provides that asset management companies should establish regular communication channels between the portfolio manager and the risk management function. The proposal aims at ensuring an effective interaction between the two functions, which should allow not affect the investment process.

#### **Box 4 – Outsourcing**

32. All respondents agreed that it should be possible to outsource risk management activities.

33. However, some respondents proposed to modify Box 4.1 providing that the management company retains “primary responsibility” for the effectiveness and appropriateness of the risk management process rather than “full responsibility”. Moreover, a small number of stakeholders invited CESR to restrict the scope of the due diligence to be carried out by the management company vis-à-vis the outsourcee “within a reasonable framework”. CESR strongly believes that the management company should retain the full responsibility for the appropriateness and effectiveness of the risk management process in the case of outsourcing, as this is crucial to ensure that the management company will make all necessary efforts to ensure the quality of the service rendered by outsourcee on an on-going basis. The principle of “full responsibility” of the outsourcer is already included in the *acquis communautaire* (see Article 14 of the MiFID Level 2 Directive). Of course, this principle would not prevent the management company to seek the responsibility of the outsourcee in case of damages resulting from a failure of the latter to perform its contractual obligations. CESR has further detailed the conditions for outsourcing, including the scope and frequency for the assessment to be made by the management company with regard to the aspects of the outsourcee’s organisation that are material to the quality of outsourced activities. Moreover, in line with the suggestion made by one respondent, CESR has provided that, prior to entering into contractual obligations and on an on-going basis, the outsourcee should conduct due diligence on the management company to ensure that it has the resources necessary to meet the necessary standards of performance.

### **PART 3 – IDENTIFICATION AND MEASUREMENT OF RISKS RELEVANT TO THE UCITS**

#### **Box 5 – Identification of risks relevant to UCITS**

34. CESR’s proposal was supported by the majority of respondents.

35. Some concerns were raised about the types of risks to be covered by the risk management process (see the section headed “General Comments” above).

36. Few respondents stressed that the responsibility for the overall risk management process, including identification of risks and definition of the risk profile, lies with the board of directors. CESR agrees that the board of directors should be responsible for the approval of the target risk profile of the UCITS and for the overall risk management process, as elaborated in the explanatory text of boxes 12 and 13. CESR takes the view that the risk management function is responsible for the identification of risks relevant to the UCITS, and that this work should be used by the board of directors to define the risk profile of the

UCITS.

37. In the consultation paper it was stated that the risk management function should not be “bound by the use of a specific risk management model”. A clarification was hoped by some respondents on this requirement. A stakeholder understood it as giving flexibility for management company not to retain the risk measurement technique imposed by national rules (for instance VaR for sophisticated UCITS) whether it considers it is not the best suited one. In that respect, CESR has clarified that management companies should not over-rely on single methodologies or specific risk models. However, CESR does not encourage management companies not to retain the risk measurement techniques imposed by national rules.
38. One respondent supported that model risks should be referred to as a material source of risks and therefore should be assessed on a frequent basis. The comment is relevant for Box 6 also. In the consultation paper, CESR has already provided that the identification of risks process should be periodically revised to allow for possible changes to the market conditions or the investment strategy of the UCITS.

#### **Box 6 – Risk measurement techniques**

39. The proposals made by CESR in Box 6 were supported by several respondents.
40. However, there were mixed views on whether the distinction between sophisticated and non-sophisticated UCITS as laid down in the EC Recommendation 2004 should be reflected in the Box. CESR is of the view that the distinction between sophisticated and non-sophisticated UCITS and related appropriate risk measurement techniques may need to be reviewed. References to high risk profiles and sophisticated/non-sophisticated UCITS were dropped at this stage. Nonetheless, the “proportionality” principle – already reflected in the explanatory text – was reinforced as proposed by some stakeholders. In particular, it was clarified that the measurement techniques should be appropriate and proportionate to the nature, scale and complexity of the management company’s activities and of the UCITS it manages. Moreover, the reference to the use of “leading market solutions” (paragraph 28 of the consultation paper<sup>6</sup>) has been deleted as suggested by some respondents. Management companies are required to employ “effective” risk measurement techniques and review them whenever necessary to ensure they remain “appropriate”.
41. Different comments were raised in relation to paragraph 27 of the consultation paper, which stated that IT risk management systems may need to be integrated with front-office and accounting systems. CESR confirms that risk management systems should be integrated with one another, and that it might also be useful to integrate them with other key applications so as to ease interactions. The initial wording remains unchanged.
42. In relation to paragraph 29 of the consultation paper, providing that “If UCITS invest in structured products, their multiple risk components should be appropriately identified and managed”, one respondent proposed that the principle should apply only “where it is feasible to do so”. Moreover, it was proposed to introduce guidance or definition of what a “structured product” is. CESR strongly believes that the risks associated with any of the components of the structured product must be appropriately identified and managed. The relevant text was clarified. It was also added that appropriate due diligence should be

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<sup>6</sup> In paragraph 28 it was stated that companies should employ sufficiently advanced risk measurement techniques, being expected to keep up to date with and consider the use of leading market solutions in the interests of investors.

conducted prior to investments in such products. If this is not feasible, such products should not be invested in by the UCITS.

43. It was suggested by some respondents not to specifically refer to operational risks as non-quantifiable risks (paragraph 31 of the consultation paper), as not all operational risks are not quantifiable. On the contrary, another stakeholder took the view that all operational risks are not non-quantifiable and insisted it was essential that management companies have appropriate operational risk management procedures in place. CESR dropped the reference to operational risks as an illustration of non-quantifiable risks. CESR confirms that only those operational risks that also affect investors' interests by their direct impact on the fund's portfolio should be considered within the scope of the present principles.
44. Some respondents proposed to include a clear reference to liquidity risks. CESR agrees that liquidity risks associated to financial instruments have to be fully considered prior to investment decisions as well as on an on-going basis. A reference to liquidity risk was already included in the consultation paper. It is now emphasised in the explanatory text that risk management techniques should be easily adapted in period of increased market turbulences.

#### **Box 7 – Management of model risk concerning the risk measurement framework**

45. Some respondents expressly indicated their support to CESR's proposal on application of model risks to any relevant UCITS. On the contrary, other respondents argued such measurement of risks is only applicable to sophisticated funds. CESR agrees that the risk model employed to measure risks should be proportionate to the complexity of the UCITS. Still, whatever its level of complexity, the risk measurement framework in place needs to be demonstrably re-assessed whenever needed.
46. According to paragraph 33 of the consultation paper, back-testing should be carried out separately for every technique used in the risk measurement framework. While some respondents expressly supported CESR's proposal on back testing, a number of stakeholders suggested to specify that back-testing should be carried out only for every "relevant" technique used in the risk management framework. CESR recognises that back-testing might not be relevant to all measurement techniques. Therefore, it is now stated that back-testing should be used "where appropriate" for "the techniques used" in the risk measurement framework.
47. Some respondents expressly supported CESR's proposal on the use of stress tests (paragraphs 35-36 of the consultation paper<sup>7</sup>). A small number of stakeholders highlighted that stress tests scenario used for each UCITS should be periodically reviewed by the risk management function, also to deal with unanticipated market developments, and that procedures should be established to deal with excesses of stress test limits. According to CESR, this point was already addressed in the consultation paper. Moreover, some respondents indicated that stress tests may not always be the most appropriate technique to capture particular risks features such as price correlation and liquidity and that the

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<sup>7</sup> "Stress tests are usually meant to capture the possibility of rare and severe losses which could occur during market shocks, and which are unlikely to be measured by the models as they tend to follow structural breaks in the functional relationships between market variables (sudden shifts of crucial model parameters). Stress tests should cover all quantifiable risks which affect, to a material degree, the value of the UCITS, with particular attention given to those risks which are not represented with sufficient accuracy by the risk models used. Such risks might include, for example, unexpected changes to price correlations or to asset (or even market) liquidity".

relevant provisions of the consultation paper were overly prescriptive. On the other hand, another respondent suggested imposing basic scenarios as it is the case for banks. In the revised paper, CESR has emphasized that stress tests should be used whenever necessary. Reference is made to changes to price correlation and liquidity as examples, which does not mean that other techniques would not be more appropriate or supplementary to stress tests.

48. Some stakeholders argued that the risk management framework should be subject to “on-going” or “periodic” assessment and revision, instead of “continuous” assessment and revision. In line with these comments, the wording of paragraph 2 of the Box was amended so that the risk management framework would be subject to “on-going” assessment and revision.

#### **Box 8 – The link between risk measurement and asset valuation**

49. Broad support was expressed by some respondents on the principle that the risk management function should support the valuation process.

50. Some respondents, whilst agreeing on this principle, considered that valuation does not fall within the scope of the risk management principles. Other stakeholders stressed the independence among the aforesaid activities and argued that the risk management function should not be directly involved in pricing assumptions and models. It was also proposed that the risk management function should choose prices that are consistent with the criteria set by the valuation function. One stakeholder took the view that asset valuation should be dealt with in more details, in particular regarding risks of conflicts of interests and the role of the depositary.

In respect of the comments above, CESR recognises that the issue of valuation may deserve further reflection. In addition, CESR clarified that the aim of the Box is rather to ensure that there is sufficient interaction between the risk management function and the valuation process so as to allow mutual support, without prejudice to the respective objectives of the above-mentioned functions. It was also clarified that this does not necessarily imply direct involvement of the risk management function in the pricing process and that the interaction may for instance result in the participation of both functions into the management company’s valuation committee, as suggested by some respondents.

51. According to paragraph 39 of the consultation paper, “If robust market prices are available, the risk measures should be computed relying on a complete and adequate time series of marked-to-market values. However, when measuring risks of illiquid assets, risk managers should thoroughly check the robustness of their estimates, testing the data used for the computation against the valuations of actual comparable trades”. CESR has taken account of the view expressed by some respondents that, in the case of illiquid assets, the testing against comparable trades should only be done where such data are available.

52. According to paragraph 40 of the consultation paper, assumptions and models underlying pricing of illiquid, structured financial instruments or complex derivatives should be consistent with the risk measurement framework used by the management company. A small number of respondents noted that it might not always be achievable to have the above-mentioned consistency and therefore suggested to have a less strong link between them. In particular, it was noted that valuation models used by front-office functions and the risk measurement framework pursue different objectives (mark-to-market valuation according to fund rules versus picture of risks under different scenarios; fair value versus worst case scenario). The formers tend to apply to a smaller set of transactions at any one time, and thus are likely to be more flexible and use more extensive data. CESR is aware that the objectives and constraints of the risk management and valuation functions are different. However, CESR confirms that there should be strong mutual support between

both functions and therefore consistency between assumptions and models used by them is needed in the case of assets requiring complex valuation.

#### **PART 4 – MANAGEMENT OF RISKS RELEVANT TO THE UCITS**

##### **Box 9 – Risk management procedures**

53. Respondents generally welcomed CESR’s proposal on Box 9.
54. Wording changes were suggested by some stakeholders in the Box 9.1 and 9.2 in relation to the role of the board of directors. In particular, it was proposed that the UCITS risk profile should be “approved” by the board, rather than “defined”. The proposal was taken on board. Moreover, it was suggested by one respondent that also the portfolio manager should be consulted by the board prior to the definition, update or change of the risk profile of the UCITS. CESR notes that this would not be prevented by the proposed principles.
55. A small number of respondents argued that the reference to the risk profile should be linked to the content of the prospectus of the UCITS. CESR recognises that the risk profile as approved by the board of directors should be coherent with the one disclosed in the prospectus. However, it is noted that the risk profile approved by the board might be more detailed than the one disclosed in the prospectus.

##### **Box 10 – Risk limits system**

56. In Box 10 CESR proposed that the risk management policy should provide, for each UCITS, a system of limits concerning the measures used to monitor and control the relevant risks.
57. A number of stakeholders called for the risk limits systems to apply only to “quantifiable” risks. CESR notes that it was already stated in the explanatory text (paragraph 45 of the consultation paper) that the limit system should “cover all risks to which a limit can be applied”.
58. Besides, for the sake of clarity, a respondent suggested to explain that such a system should be based on legal and contractual limits, which could also be supplemented by additional internal limits defined by the management company. CESR supports this view. The revised explanatory text states that legal, contractual and other internal limits should be taken into account in the risk limit system.
59. Besides, a number of respondents were concerned about paragraph 45 of the consultation paper since that it might not be necessary or even feasible for every transaction to be “immediately” taken into account into the calculation of the corresponding limits for all risks. They propose therefore to remove the word “immediately”. On that aspect, another respondent explained that “immediate” accounting would imply a trade-off between timeliness, where transaction data is sourced from trade capture systems and quality, which tends to be higher where data is obtained from the company’s books and records. So companies should be allowed to use the second approach as long as it does not imply undue delay. CESR took those comments into account and removed the word “immediately”.
60. Regarding the obligation in paragraph 46 of the consultation paper to keep records of cases in which limits are exceeded and the action taken, it was observed that this obligation should concern only the cases when “regulatory limits” are exceeded. On that aspect, CESR believes it is important that record is kept of excesses to all limits.



### **Box 11 – Effectiveness of the risk management process**

61. According to Box 11, the risk management policy should define procedures that, in the event of breaches to the risk limit system of the UCITS, result in a prompt correction of the portfolio and provide for the timing of this. Whilst some respondents expressly supported CESR’s proposal, few others raised concerns on the requirement for a “prompt correction” of the portfolio in the event of breaches to the risk limit system of the UCITS, as indicated below. These comments are also relevant for Box 12 below.
62. In particular, some respondents considered that only material breaches should be immediately reported to the board. Other respondents proposed that only breaches (or active breaches) of regulatory limits should be corrected immediately. Moreover, a number of respondents pointed out that a “prompt” correction of the portfolio in case of breaches to the risk limits might not necessarily be in the best interest of UCITS investors. They considered that the type of corrective action and its timeframe should be evaluated by the board according to the best interest of UCITS. CESR amended the content of the Box. The scope of breaches covered in Box 11 is now the following: “actual and anticipated breaches to the risk limit system”. The reference to “prompt correction” was replaced by “timely remedial actions”. In addition, the explanatory text now states that the appropriateness and timing of remedial action needs to be evaluated in the best interest of unit-holders.
63. Paragraph 48 of the consultation paper provides that the risk management process should allow warning to be generated so that appropriate measures may be taken on a timely basis to prevent breaches. Whilst agreeing with this principle, some respondents expressed concerns in relation to the proposal in the subsequent paragraph 49 that stress tests may contribute to the generation of exceptional warnings which should be adequately taken into account within the investment decision-making process. In particular, they supported that the use of specific risk assessment measures such as stress testing should be left to the discretion of the management company or the portfolio manager or deserve further thought. CESR agrees that the risk management process should not prejudice the role of portfolio managers and decision-making process. However, it is important that the risk management function is able, based on the interaction with other functions, to anticipate the need for specific techniques, such as stress tests, and that such techniques are taken into account in the decision-making process.

## **PART 5 – MONITORING AND REPORTING**

### **Box 12 – Reporting to the Board of Directors and the Senior Management**

64. In Box 12.2 CESR provided that the risk management function should report regularly to the senior management and, if necessary, to the heads of the different operational departments, highlighting the current level of the risks relevant to the UCITS, and outlining any actual or expected breaches to their limits to ensure prompt and appropriate action is taken.
65. Whilst some respondents expressly supported CESR’s proposal on Box 12, few others proposed to simplify Box 12 and 13 and to adopt a more principles-based approach. Other respondents proposed to delete reference to “expected” breaches and to soften the reference to “in-depth analysis” in paragraph 3 of Box<sup>8</sup>.

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<sup>8</sup> Box 12.3 provides that “Periodic written reports should be submitted to the Board of Directors, providing an in-depth analysis of the consistency between the actual risks and the risk profile of the UCITS as defined by the Board of Directors”.

66. CESR is of the view that appropriate and timely reporting to the Board of Directors and Senior management is key in the risk management process in order to allow for appropriate and timely reactions. It is necessary to establish common standards in terms of how such reporting should be made. Some amendments have nonetheless been introduced compared to previous text. For instance, “an in-depth analysis” on the consistency between the actual risks and the UCITS risk profile is required to be provided only “where appropriate”. Moreover, reference to “expected breaches” was replaced by “foreseeable breaches”.

### **Box 13 – Monitoring of the risk management process**

67. CESR’s proposal on Box 13 was generally welcomed.

68. However, few respondents disagreed with the need for the risk management function to also report to a supervisory function, as it should be sufficient for the board of directors to receive such reports, or invited to clarify what supervisory function means. The reference to the need to report to the supervisory function, if any, has been kept. The supervisory function was defined as the function appointed to examine and evaluate the adequacy and effectiveness of the risk management process, taking into account that such a function may exist in some Members States under different forms.

69. One respondent proposed to delete paragraph 2 of Box 13, which provides that the risk management function should review the adequacy and efficiency of measures taken to address any deficiency in the risk management process, because it could suggest that the risk management function should assess its own work. CESR confirms that the risk management function should review and report on the adequacy and effectiveness of the measures taken to address deficiencies and be able to propose adjustments where necessary. CESR has however clarified that the board of directors should ensure that the risk management function itself is subject to appropriate review.

70. Paragraph 3 of Box 13 provides that the risk management process should be subject to appropriate internal or external independent oversight. Some respondents suggested clarifying that the paragraph refers to internal and external “auditors”. The suggested clarification on the reference to internal and external auditors was introduced in the explanatory text.

**Annex 1 – List of respondents (18)**

	<b>Respondent</b>
1.	Assenagon
2.	Assogestioni
3.	Citi
4.	Investment Management Association
5.	European Fund and Asset Management Association
6.	Association of the Luxembourg Fund Industry
7.	European Savings Banks Group
8.	Bundesverband Investment und Asset Management
9.	FIL International
10.	Gutmark, Radtke & Company
11.	Matheson Ormsby Prentice
12.	Risk Metrics Group
13.	Irish fund industry association
14.	CFA Institute
15.	Vereinigung Osterreichischer Investment Gesellschaften
16.	Depositary and Trustee Association
17.	Association Française de Gestion
18.	Austrian Bundesparte Bank und Versicherung