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UCITS Liquidity and the Risk Management Framework - Ensuring compliance with EU and Irish regulatory guidance

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UCITS Liquidity and the Risk Management Framework

UCITS or ‘undertakings for collective investment in transferable securities’ have been one of the great financial success stories of the European Union (“EU”) with total assets held in these vehicles exceeding €12 Trillion by 2021 and the UCITS authorisation ‘brand’ having come to be viewed as an international standard of good practice. This has facilitated sales of UCITS throughout the world and not just across the EU, where such structures are authorised and have a legal right of distribution.

One of the primary selling points of UCITS is the liquidity they afford- with a requirement for at least two dealing days a month but many such funds providing for daily dealing. However, as a result of concerns pertaining to the actual liquidity of UCITS generated by some specific issues, regulators have been focusing on this and the underlying liquidity risk management framework (the “**LRM Framework**”) pertaining to UCITS operated by their management companies. As a result fund management boards are currently under an obligation to conduct a documented review of their related processes and ensure compliance by year end 2021 at the latest. This article explores the background to this issue, including relevant legislation and regulatory guidance, and examines the specific requirements applicable before outlining appropriate steps to take to ensure full compliance.

Background

While liquidity has always been a core element of the UCITS product this really came to the fore in the wake of the 2007-2009 financial crisis (the “**Financial Crisis**”). Such were the concerns of some investors with the gating and illiquidity that they encountered with private fund vehicles that UCITS saw a renewed surge of interest from global professional investors and allocators. As a result significant numbers of managers who had been accustomed to using such, typically offshore, private fund structures sought to instead launch UCITS versions of their strategies in order to capitalise on investor demand for

vehicles with obligatory liquidity provisions enforced by regulation.

However, long after the difficulties of shoehorning certain hedge type strategies into UCITS became apparent, the practical realities pertaining to compliance with the required liquidity of UCITS was brought into sharp focus by issues encountered by the Woodford funds in 2019. In that case significant redemptions to the LF Woodford Liquidity Income Fund exposed the fact that certain securities in the fund portfolio, while technically permitted, were not as liquid as would be anticipated for a UCITS, ultimately leading to the fund having to be suspended and then wound up¹. This raised broader concerns as being perhaps symptomatic of a wider trend to “push the envelope” to facilitate certain underlying investments being deemed eligible assets for UCITS by virtue of technical attributes rather than the genuine transferability, marketability and, ultimately, the liquidity expected. Further concerns around the liquidity of fund portfolios were occasioned by the market shocks encountered as the Covid-19 pandemic impacted world markets. As a result, we have seen significant regulatory focus on liquidity issues for UCITS, which included additional liquidity reporting being required by regulations in both Ireland and Luxembourg as an emergency measure. This has led to UCITS management companies being currently under specific obligations to ensure that they are addressing the related concerns identified.

¹ See “ [Update on LF Woodford Equity Income Fund | FCA](#)”

<https://www.fca.org.uk/news/statements/update-lf-woodford-equity-income-fund>

Regulatory Activity and Guidance

The European Systemic Risk Board (“ESRB”) investigated liquidity risks in EU investment funds in 2020 and identified five priority areas for consideration (the “**ESRB Priorities**”). It also issued a recommendation to the European Securities and Markets Authority (“**ESMA**”) in May 2020 to carry out a related supervisory exercise². ESMA launched a common supervisory action (“**CSA**”) amongst the national competent authorities (“**NCA**s”) across the EU/EEA to conduct a coordinated supervisory investigation into UCITS liquidity risk management commencing in early 2020. This was aimed at investigating whether UCITS had appropriate liquidity management practices in place. Analysis of quantitative data pertaining to significant numbers of relevant funds was supplemented by in-depth analysis of a sample of managers and UCITS. While ESMA reported that the overall findings across the 30 NCAs were generally positive, significant shortcomings were identified and outlined in ESMA’s public statement on the results of the CSA³, issued in March 2021 (the “**ESMA Guidance**”). The findings of the ESMA Guidance are stated to be generally applicable and UCITS managers should ensure compliance with this. It also noted that individual NCAs would be responsible for following up with the market participants they regulate as they have responsibility for effectively mitigating risk in their individual jurisdictions.

Consequently, in May 2021 the NCA for Ireland, the Central Bank of Ireland (the “**CBI**”) circulated

a “Dear Chair” letter (the “**CBI Letter**”) outlining the supervisory work undertaken, highlighting 9 specific areas of concern and indicating its related expectations for Irish UCITS Management companies⁴.

The CBI Letter, although issued in response to the ESMA Guidance, followed earlier correspondence which the CBI had already published on the issue of liquidity management. The CBI had issued letters in August 2019 and April 2020 to fund management companies focusing on the importance of effective liquidity management. These were primarily composed in the context of Brexit preparedness and the Covid-19 pandemic, respectively. The CBI also issued a letter to specific firms which had been selected to be part of the CSA review conducted in 2020 on 10th March 2021 (the “**CBI March Letter**”). The guidance in these earlier and focussed letters is also of relevance in ensuring that a firm’s LRM Framework is appropriate, and the CBI Letter specifically references the CBI March letter in this regard (which in turn references its earlier related correspondence). The CBI also issued a Dear Chair letter following its “**Thematic review of fund management companies’ governance, management and effectiveness**” in October 2020 which also contains some points of relevance for the LRM Framework.

This article focuses on the obligations of Irish UCITS management companies to ensure compliance with the CBI Letter, noting that the ESRB Priorities and the ESMA Guidance are also applicable and, to the extent that there is any

² See its report “Recommendation of the European Systemic Risk Board (ESRB) on liquidity risk in investment funds” [esma34-39-1119-report on the esrb recommendation on liquidity risks in funds.pdf \(europa.eu\)](https://www.esma.europa.eu/press-information/2020/esma34-39-1119-report-on-the-esrb-recommendation-on-liquidity-risks-in-funds.pdf)

³ See “Public Statement: ESMA presents the results of the 2020 Common Supervisory Action (CSA) on UCITS liquidity risk management”, 24 March 2021: [esma_34-43-880-public-statement-2020-csa-ucits-liquidity-risks-management.pdf \(europa.eu\)](https://www.esma.europa.eu/press-information/2021/esma_34-43-880-public-statement-2020-csa-ucits-liquidity-risks-management.pdf)

⁴ For the purposes of this article the findings are identified numerically in the order they appear on page 3 of this letter and then as elaborated upon in Appendix 1. The letter is available at: [Industry Letter - Common Supervisory Action on UCITS Liquidity Risk Management \(centralbank.ie\)](https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/industry-letter---common-supervisory-action-on-ucits-liquidity-risk-management-19-may-2021.pdf?sfvrsn=5) Available at: <https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/industry-letter---common-supervisory-action-on-ucits-liquidity-risk-management-19-may-2021.pdf?sfvrsn=5>.

divergence, are additional to the requirements of the CBI Letter⁵. Furthermore, the other relevant items of correspondence from the CBI on liquidity identified above should also be considered when finalising the LRM Framework in order to ensure full compliance and best practice with all the relevant guidance mentioned (together the “**LRM Guidance**”).

Legal Requirements

Prior to undertaking an analysis of the requirements contained in the LRM Guidance it is useful to note the specific provisions of the underlying UCITS legislation which are relevant and upon which such guidance has been based. In the Irish context these are the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011 (S.I. No. 352/2011) (the “**Irish UCITS Regulations**”) and the Central Bank (Supervision and Enforcement) Act 2013 (section 48(1) (Undertakings for Collective Investment in Transferable Securities) Regulations 2019 (the “**Central Bank UCITS Regulations**”).

This legislation provides that UCITS managers are required to establish, implement and maintain an adequate and documented risk management policy identifying the risks the UCITS they manage may be exposed to⁶ and to ensure that the liquidity profile of the investments of the UCITS are appropriate to its redemption policy⁷.

In order to ensure compliance with these obligations UCITS management companies are required, where appropriate, to formulate forecasts and perform analyses regarding

individual investment’s contributions to UCITS portfolio composition, liquidity and risk and reward profile prior to making investments⁸. The legislation also includes granular provisions to assist with the assessment of liquidity risk in relation to both transferable securities and investments not admitted to trading on a regulated market, as well as addressing related documentation requirements⁹. Stress testing and scenario analysis are also required where appropriate¹⁰.

The risk management policy must state the terms, contents and frequency of reporting to the board¹¹ and adequate internal control mechanisms must be established, implemented and maintained to secure compliance at all levels¹². There is also an obligation to periodically review the adequacy of risk management policies and procedures¹³.

UCITS are obliged to have a risk-management process which enables it to monitor and measure at any time the risk of the UCITS’ positions and their contribution to the overall risk profile of the portfolio of assets of the UCITS¹⁴. The LRM Framework will accordingly be a sub-set of the overall risk management framework.

Note that the legislation contains references to both a risk management policy and a risk management process. In many cases firms have sought to ensure compliance with the related obligations by addressing the requirements pertaining to both in a single document - the risk management process or RMP. However, as

⁵ The CBI Letter contains 9 key findings, which are elaborated upon in the Appendix to the letter. The ESMA Guidance notes 11 topics, indicative of a slightly broader scope.

⁶ Paragraph 1(a) of Schedule 9 of the Irish UCITS Regulations

⁷ Paragraph 10 of Schedule 9 of the Irish UCITS Regulations

⁸ Paragraph 8(1) of Schedule 5 of the Irish UCITS Regulations

⁹ Regulation 4(2) of the Central Bank (Supervision and Enforcement) Act 2013 (section 48(1) (UCITS)

Regulations 2019 (the “Central Bank UCITS Regulations”)

¹⁰ Paragraph 9(2) of Schedule 9 of the Irish UCITS Regulations

¹¹ Paragraph 2 of Schedule 9 of the Irish UCITS Regulations

¹² Paragraph 1(c) of Schedule 4 of the Irish UCITS Regulations

¹³ Paragraph 8(1) of Schedule 5 and Paragraph 4 of Schedule 9 of the Irish UCITS Regulations

¹⁴ Regulation 69 (1)(a) of the Irish UCITS Regulations

detailed further below, it is more appropriate for these to be separate.

Additional Guidance

The composition of the LRM Guidance and its various elements have been highlighted above as well as its underlying legislative basis. However, it is appropriate to note that other elements of existing CBI guidance also impact on this area and the LRM Guidance includes analysis of the extent to which such guidance has been complied with. Accordingly, the LRM Guidance should not be considered in a vacuum but rather must also be viewed in light of such additional applicable guidance

For example, the CBI's guidance for fund management companies issued in December 2016 (the "**FMC Guidance**") details the general requirements for the risk management framework¹⁵ and requires agreement on appropriate thresholds and key performance indicators that would trigger immediate escalation of issues to the board from delegates or designated persons, as appropriate¹⁶. This was specifically cited in the CBI Letter and highlighted as an area of shortcoming identified under Finding 3 of that letter. In addition to such general points, liquidity is also specifically addressed in the FMC Guidance, which notes the necessity of having processes for the management of liquidity risks, including the potential for liquidity mismatches between assets and liabilities, and the actions to be taken

to mitigate them¹⁷, the need for the general risk management framework to address liquidity risk, including the risk of investor redemptions requiring the disposal of assets of limited liquidity¹⁸ and for the investment risk appetite to be set having regard to the liquidity of the assets in which the fund(s) invests.

Similarly, the CBI's UCITS Q&A also addresses points of relevance, including compliance with the liquidity stress testing obligation¹⁹. Such earlier relevant guidance is also explored further below and these should also be embodied into the construction of the LRM Framework.

In addition, as noted above, European level guidance also exists and is applicable. This also includes the recommendations from the European Systemic Risk Board to ESMA on liquidity risks in investment funds²⁰ and ESMA's Guidelines on liquidity stress testing in UCITS and AIFs²¹

SMICs V Manco

The LRM Guidance applies to both UCITS structured as "SMICs" (self-managed investment companies) and those with separate management companies. However, primary responsibility for the LRM Framework under applicable legislation pertains to the UCITS management company. To date the SMIC model has been the prevalent model for UCITS in the Irish market but in light of the CP86 reforms, as well as other drivers including Brexit²² we are witnessing a significant transition to the use of

¹⁵ Part I, C "Risk Management", FMC Guidance, CBI, December 2016

¹⁶ Part IV, Paragraph 21 of the CBI's FMC Guidance, December 2016

¹⁷ Part I, A, Paragraph 37 of the CBI's FMC Guidance, December 2016

¹⁸ Part I, A, Paragraph 37 of the CBI's FMC Guidance, December 2016

¹⁹ Question ID 1095, "Liquidity Stress Testing", UCITS Q&A, CBI, 32nd Edition, 29 July 2021 <https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/ucits/guidance/ucits-q-a-32nd-edition.pdf?sfvrsn=4>

²⁰ Available at:

https://www.esma.europa.eu/sites/default/files/library/esma34-39-1119-report_on_the_esrb_recommendation_on_liquidity_risks_in_funds.pdf

²¹ ESMA, 2020, available at:

https://www.esma.europa.eu/sites/default/files/library/esma34-39-897_guidelines_on_liquidity_stress_testing_in_ucits_and_aifs_en.pdf

²² See our CP86 related articles for further information on related considerations. These are available on our website at the link below: <https://www.clerkinlynch.com/services/asset-management-and-funds/>

separate management companies for Irish domiciled UCITS.

Accordingly, the related responsibility for boards of UCITS structured as corporate vehicles (investment companies or ICAVs) which have appointed a separate management company (i.e. do not constitute SMICs) will be to ensure that the management company has established, maintains and operates compliant procedures – but the fund’s board is ultimately responsible for ensuring compliance. Indeed the CBI has specifically confirmed that:

“the board of an externally-managed investment company retains ultimate responsibility for its management, including the appointment and oversight of the fund management company, which is its principal delegate”²³

The CBI notes that the precise relationship between a fund board and the management company it has appointed to the UCITS may vary from case to case but, noting the overall responsibility of the fund board, the obligation is that:

“the board of the externally-managed investment company should satisfy itself that its relationship with the fund management company is such that the relevant board responsibilities are discharged, and that the fund management company performs the relevant tasks it is required to undertake to an appropriate standard”²⁴

As such the fund board’s role is essentially one of oversight. However, it is worth noting that the board of the externally-managed fund also retains responsibility for the prospectus of the UCITS²⁵ and given that key elements of the LRM Framework highlighted in the LRM Guidance, such as redemption policy, inclusion of liquidity management tools (anti-dilution levies or swing pricing) etc will be required to be addressed in

the prospectus this does, in practice, impose an obligation on the fund board to give direct consideration to such issues. Accordingly, they should be cognisant of related matters when approving the prospectus.

In light of applicable regulatory scrutiny and the volume of applicable related regulation and guidance, fund boards may wish to consider requesting an independent review of the related measures put in place where an external management company has been appointed, as well as potentially having periodic assessments conducted in this regard.

An appropriate Liquidity Risk Management Framework

The LRM Guidance highlights shortcomings identified in reviews by the regulatory authorities as well as key areas to focus on and as such constitutes a valuable resource to assist in ensuring that an appropriate LRM Framework is prepared. This section of this article focuses on the key aspects of this, including: the nature of the required documentation, the key constituent documents required, core generic elements to feature and then some practical aspects of embedding all of this across the documentation pertaining to the UCITS.

Nature of the required documentation

-Form

The requirement is for there to be a single cohesive documented LRM framework pertaining to the UCITS²⁶. This does not necessarily need to be (and in fact is unlikely to be) a single document as it shall encapsulate aspects of various policies covering multiple areas (e.g. valuation, distribution etc.) as discussed further below. At the most basic level to show “definition” and “cohesion” it would need to comprise an index referencing all aspects of the necessary comprehensive framework to the extent they exist as separate documents (including the separate policies and procedures etc) but ideally it would go beyond

²³ See Part I (F) (55) of the FMC Guidance

²⁴ See Part I (F) (58) of the FMC Guidance

²⁵ See Part I (F) (57) of the FMC Guidance

²⁶ Finding 1, CBI Letter

that and elaborate on the relationship between these, so that a single source document explains the overall framework as well as citing the various constituent elements. Having a single such document would also ensure related regulatory inquiries could be dealt with expeditiously and meet related criticisms²⁷.

Where separate documents are used cross referencing throughout the materials is appropriate to demonstrate the required element of cohesion. Indeed when we explore the required elements of a LRM Framework it will become apparent that cross referencing and interplay will be essential to provide for the required cohesiveness while simultaneously ensuring all the necessary elements are adequately addressed.

-Aspect

Rather than merely entailing the analysis of historic or even contemporary data pertaining to the UCITS, the LRM Framework is required to be “forward looking”²⁸. The implications of this are that when significant new initiatives are being planned and approved, for example new distribution arrangements or launches of new sub-funds, the implications of such initiatives on the risk profile of the UCITS also needs to be considered. As such the process for the approval of any such initiative will need to include a review under the terms of the LMF Framework and, where appropriate, updating it to reflect them. The CP86 reforms assigned a more central role to the distribution function and essentially require management to take a holistic view of the implications of related actions on the UCITS as a whole, rather than addressing these in a segregated and effectively box ticking manner. This is a further example of this obligation to adopt a holistic and pre-emptive approach in UCITS management²⁹. The future focus is also

relevant in the context of investments, with a failure to adequately provide for pre-investment forecasting frameworks or processes being key shortcomings identified in the CBI Letter³⁰.

-Flexibility

The LRM Framework needs to be tailored to reflect the “nature, scale and complexity of the UCITS”³¹ and as such there is no “one size fits all” but rather it should be tailored specifically for each UCITS, bearing in mind the principle of proportionality and with a consequent greater or lesser emphasis on different elements depending on a range of factors. This also means that the scope and extent of the LRM Framework would be expected to change over the lifecycle of each UCITS, in particular if it experiences significant growth or engages in materially different activities. This should be a primary consideration during the review process (addressed below), rather than only focusing on new regulatory updates impacting documentation. At the more micro level, the ongoing requirement is for the LRM Framework to be live and adaptable³². Accordingly processes to both facilitate these aspects and also demonstrating that they are the case in order to respond adequately to any regulatory review should be included. This aspect is addressed further under the “Review” and “Escalation” headings in the “Key Elements” section below. Flexibility and adaptability are also attributes to be embedded in the processes undertaken. For example, stress testing³³ should take account of multiple scenarios and there should be flexibility applied to the assumptions underlying related analysis to assess the implications where they no longer apply. Indeed rigidly applying assumptions, such as an over

²⁷ Finding 1 of the CBI Letter specifically criticises addressing liquidity risk with an assortment of procedures referencing the area rather than a cohesive framework. Similarly a lack of clarity in, or absence of, documentation is cited by ESMA at Paragraph 11 (I) of the ESMA Guidance

²⁸ Finding 1, Appendix 1, CBI Letter

²⁹ See our related analysis contained in articles on CP86 available at this link:

<https://www.clerkinlynch.com/services/asset-management-and-funds/>

³⁰ Findings 2 and 4, CBI Letter

³¹ Paragraph 3 of Schedule 9 of the Irish UCITS Regulations

³² Finding 1, Appendix 1, CBI Letter

³³ Paragraph 9(2) of Schedule 9 of the Irish UCITS Regulations. See also Section 1.4, ESMA Guidelines on liquidity stress testing in UCITS and AIFs, ESMA, 2020

reliance on the presumption of ongoing liquidity, has been identified as a specific shortcoming to avoid³⁴ and related concerns have been well illustrated in practice during periods of market disruption such as the Covid-19 pandemic and the Financial Crisis.

- **Constituent Documentation**

-Risk Management Policy AND Risk Management Process

The risk management policy will constitute the core of the LRM Framework. The key elements of this are prescribed in the relevant legislation³⁵ and the CBI Letter has highlighted shortcomings in addressing aspects of these. In practice it has become common for related aspects to be addressed in a single document, the risk management process or “RMP”. This likely arose primarily as the legislation provides that the risk management policy shall comprise such procedures as are necessary to “enable the management company to assess...the exposure of the UCITS to market liquidity and counterparty risks...³⁶” and there are detailed requirements pertaining to the constituent requirements of the RMP included in the legislation (discussed further below)³⁷. Furthermore, the ESMA Guidelines provide for the liquidity stress testing policy to be contained in the RMP³⁸.

However, noting the LRM Guidance it seems preferable and more appropriate for the risk management policy to be a separate document. This arises because:

- The CBI requires a confirmation be given that “*the RMP is proprietary to the UCITS (i.e. not the management company)*”³⁹ but the requirements pertaining to the risk management policy are stated in the legislation to accrue to the management company, not the UCITS;
- The RMP is required to be signed by and furnished on the headed paper of the risk manager to the UCITS, who in practice (at least in the case of SMICs) will typically be the investment manager⁴⁰. However, the risk management policy will be broader in scope than the RMP as it should also address issues such as valuation, redemption policy, use of liquidity management tools etc. (discussed further below), which will normally remain the responsibility of the management company and go beyond the scope of the role delegated to the investment manager (and aspects of which may have in part been delegated to another of its delegates, such as the distributor);
- While, as noted above, the ESMA Guidelines provide that the liquidity stress testing policy should be contained in the RMP⁴¹, the CBI has noted that responsibility for ensuring this is in place under the legislation lies with the management company and “*As such, it may be appropriate for the liquidity stress testing policy to be documented within the risk management policy of the UCITS*”

³⁴ Finding 5, CBI Letter

³⁵ See the paragraph entitled “Legislation” above and the references included

³⁶ Paragraph 1(b) of Schedule 9 of the Irish UCITS Regulations

³⁷ See Schedule 9 of the Irish UCITS Regulations, for example.

³⁸ Section 1.4, ESMA Guidelines on liquidity stress testing in UCITS and AIFs, ESMA, 2020, available at: https://www.esma.europa.eu/sites/default/files/library/esma34-39-897_guidelines_on_liquidity_stress_testing_in_ucits_and_aifs_en.pdf

³⁹ Point 1.5, Section 13 UCITS RMP Application Form, CBI

⁴⁰ Point 1.2, Section 13 UCITS RMP Application Form, CBI- even though in practice it will typically be substantially drafted by the Designated Persons or consultants to the UCITS. Interestingly ESMA’s review findings note the need to separate risk management and portfolio management and express concern with them even being carried out by the same delegate (see point 11 (VI) of the ESMA Guidance) so best practice would be to avoid this.

⁴¹ ESMA Guidelines on liquidity stress testing in UCITS and AIFs, section 1.4

*management company*⁴²(rather than the RMP from the investment manager); and

- The CBI Letter notes the necessity for the LRM Framework to be “independent”⁴³, however if it is primarily contained in the RMP, which is typically the responsibility of the Investment Manager to the UCITS, this would mitigate against the realisation of this requirement.

While the legislation requires the risk management policy to comprise necessary procedures for risk assessment, these are a sub-element of it for the purposes of the overall LRM Framework and, having been referenced in the policy, can be fully detailed in the RMP. Nor is there necessarily any need for duplication. To the extent relevant matters are addressed in detail in the RMP, the Risk Management Policy of the management company can simply note that responsibility for the applicable procedures pertaining to relevant elements of the policy has been delegated to the investment manager and is detailed in the RMP. As such, the relevant points will be addressed in a relatively macro or generic manner in the policy and which will then refer to the RMP, which will contain more granular fund specific detail. This approach will also facilitate management companies wishing to service multiple UCITS, which may have very diverse investment parameters and consequently risks and for whom the principle of proportionality may mean widely different levels of detail in the RMP are appropriate. Some management companies may of course run their own independent analysis rather than just relying on reporting from the risk team in a delegate

investment manager - and this is certainly best practice⁴⁴.

Material changes to the RMP need to be filed with the CBI whereas changes to the risk management policy do not, so from a flexibility perspective it is preferable to only address the specifically required items in the RMP and to include other items in the policy or other documentation. Separating the policy from relevant processes also assists in fostering and demonstrating independence— particularly where different parties are responsible in each case.

Focusing now on the RMP, there are detailed legislative requirements applicable to the preparation of this document, which is required to be filed with the CBI and any material changes must be notified to it⁴⁵. The requirement for the RMP document initially arose as a result of the UCITS III reforms which permitted investment by UCITS into financial derivative instruments (“FDI”). Consequently, it is largely focussed on related matters including valuation of FDI⁴⁶, their global exposure, leverage generated and counterparty exposure etc⁴⁷. However, the RMP has subsequently been expanded in scope⁴⁸ to address assessing risks more broadly, including liquidity risks associated with transferable securities⁴⁹ and so that, as we have seen, some parties include significantly broader headings, including liquidity management within it. (It is beyond the scope of this article to go into such elements in greater detail other than to note that they apply).

With regard to the risk management policy, this must identify the potential risks the UCITS may be exposed to⁵⁰. Pre-investment forecasting is identified as a key part of this⁵¹, underpinned by

⁴² Question ID Question ID 1095, “Liquidity Stress Testing”, UCITS Q&A, CBI, 32nd Edition, 29 July 2021

⁴³ Finding 1, Appendix 1, CBI Letter

⁴⁴ See footnote 40 above and in particular the reference to ESMA’s concerns on one delegate performing risk and portfolio management.

⁴⁵ Paragraph 5 of Schedule 9 of the Irish UCITS Regulations. UCITS Form Section 13 is used for filing this.

⁴⁶ Regulation 69(b) of the Irish UCITS Regulations

⁴⁷ Schedule 9 1 (a) of the Irish UCITS Regulations

⁴⁸ UCIT IV added liquidity risk monitoring to the relevant obligations pertaining to UCITS.

⁴⁹ Schedule 2 (1) (g) of the Irish UCITS Regulations

⁵⁰ Schedule 9 of the Irish UCITS Regulations

⁵¹ Schedule 5(8) of the Irish UCITS Regulations

a documented framework with a clearly defined methodology. Failure to conduct such forecasting was a specific criticism of the CBI Letter⁵². Such forecasting should be conducted at the individual investment level and undertaken on the basis of the granular details set out in the legislation⁵³. This is particularly the case for less liquid securities such as those not listed or actively traded, although it is noted that over reliance on a presumption of ongoing liquidity for any securities is inappropriate⁵⁴. Forecasting must also include scenario analysis and stress testing (noting that ESMA has issued related guidance⁵⁵). In terms of risks. Some will of course be particular to the asset class and regions invested in. Periodic review and update.

Other policies pertaining to the UCITS will be impacted by the LRM Guidance and accordingly should form part of the LRM Framework. Examples of other policies impacted are included below:

-Distribution policy

The LRM Framework will influence the distribution strategy of the UCITS and it is important to note the appropriate interplay between these. The CBI Letter states that commercial decisions pertaining to distribution should not influence decision making within the LRM Framework – rather the channels chosen for distribution including platforms and sub-distribution networks should reflect the liquidity profile of the UCITS and not the other way around. It can of course be noted that as part of the CP86 reforms distribution has assumed a more central aspect to fund design and approval. This can accordingly be construed in that light as also requiring the LRM Framework to be an aspect to be considered ab initio in the fund design process, rather than as something to be

separately tacked on as an afterthought. Of course, actual sales can take a very different profile to that anticipated and accordingly analysis of the actual investor base on an ongoing basis is necessary⁵⁶. As such it is appropriate to have a policy pertaining to monitoring the investor base to facilitate analysis as to how this might impact redemption patterns. Primary responsibility for preparation of this may fall under the distribution function as it would be expected to typically undertake such analysis as part of the marketing process and it may make sense to add this as a sub-heading within the distribution policy rather than constituting a stand-alone policy. However, to assist with compliance from a liquidity perspective additional inputs and level of detail may be appropriate to those expected or required from a purely marketing perspective.

-Valuation Policy

It is a requirement that as part of their ongoing role management companies should ensure that valuation procedures cover all market situations, including valuation approaches for stressed market conditions. In addition, the delegation arrangements should be reviewed to ensure that the team in charge of the valuation has sufficient expertise and access to information to analyse the reliability of the valuation sources it uses and establish a fair valuation of the portfolio⁵⁷. Consequently, these aspect should be integrated into the valuation policy.

-Delegation Policy

Following on from the foregoing, ensuring that appointment and then ongoing oversight of delegates is adequate is a corollary to these requirements⁵⁸. Failure to carry this out would

⁵² Finding 4, CBI Letter

⁵³ See schedule 9 of the Irish UCITS Regulations and the Central Bank UCITS Regulations

⁵⁴ Finding 5, CBI Letter

⁵⁵ "Guidance in liquidity Stress testing in UCITS and AIFs", ESMA, 2019 (effective September 2020)

⁵⁶ Failure to adequately consider the profile of the investor base was a shortcoming identified in the CBI Letter under Finding 1

⁵⁷ See ESMA's "Recommendation of the European Systemic Risk Board (ESRB) on liquidity risk in investment funds" and Findings 6 and 7 of the CBI Letter which focus on shortcomings in delegate oversight and deficiencies in designated persons and Findings 2 and 4, which focus on deficiencies in forecasting.

⁵⁸ Finding 6, CBI Letter

also be indicative of a shortcoming in the internal control framework⁵⁹

-Other Policies

The foregoing notes some of the key policies that will form part of the overall LRM Framework but it is by no means exhaustive. For example, where liquidity management tools such as anti-dilution levies or swing pricing (addressed further below) are provided for with regard to a UCITS then the policies regarding the practical application of these measures will also be key elements⁶⁰. Accordingly fund managers should consider the need for policies and their inclusion in the LRM Framework on a case by case basis.

-Risk Appetite Statement

The risk appetite statement is a key part of the overall risk framework. It should be appropriate and proportionate to the nature, scale and complexity of the activities of the fund management company and the investment fund(s) under management⁶¹. As noted above, management of liquidity risks is specifically required to be addressed in this⁶² and the investment risk appetite should be set having regard to the liquidity of the assets in which the fund(s) invests⁶³ including the potential for liquidity mismatches between assets and liabilities (including the risk of investor redemptions requiring the disposal of assets of limited liquidity) and the actions to be taken to mitigate such risks⁶⁴. UCITS management companies are subject to a specific legal obligation to ensure the liquidity profile of the investments held by the UCITS are appropriate to the redemption policy⁶⁵.

-Risk Register

The risk register is another required element of the LRM Framework but an aspect which the CBI has specifically noted some entities have been deficient with regard to⁶⁶ and accordingly a priority area for focus.

Characteristic Elements

In light of the guidance in the CBI Letter and the shortcomings identified therein it is evident that some LRM Frameworks, while potentially addressing many of the technical requirements of the applicable legislation, have failed to include some of the key generic characteristics of an effective policy as required. It is worth reiterating here that compliance with the requirements applicable to preparing and maintaining the LRM Framework require adherence not only to the CBI Letter but also the ESMA Guidance and the ESRB Priorities (as stated in those documents) as well as earlier relevant guidance. Bearing this in mind, this section highlights a (non-exhaustive) list of some key characteristics or elements which managers should ensure feature in the LRM Framework based on the foregoing:

-Identifying All Parties to input

Failure to ensure all relevant parties input and sign off on the LRM framework, has been identified as being indicative of a shortcoming in the internal control framework and as such a failure to comply with applicable law⁶⁷. Accordingly, it is appropriate to ensure all parties required to provide input, both periodically and on updates being made, are identified and ideally to maintain a log of them having completed their review⁶⁸. Ideally the source of any comments provided would also be logged

⁵⁹ Finding 9, CBI Letter

⁶⁰ Indeed ESMA has identified increasing the availability of such policies as a priority- see Priority area 4 of the ESRB Priorities

⁶¹ Part I, C, Paragraph 33, FMC Guidance, CBI, December 2016

⁶² Part I, A, Paragraph 37 of the CBI's FMC Guidance, December 2016

⁶³ Part I, A, Paragraph 38 of the CBI's FMC Guidance, December 2016

⁶⁴ "Thematic review of fund management companies' governance, management and effectiveness" CBI, October 2020

⁶⁵ Schedule 9, 10 of the Irish UCITS Regulations

⁶⁶ "Thematic review of fund management companies' governance, management and effectiveness" CBI, October 2020

⁶⁷ Finding 9, CBI Letter

⁶⁸ See "Log" below.

and recorded by way of further evidence and to be used to satisfy related regulator inquiries. This is especially appropriate for larger or more developed fund complexes where a myriad of policies apply and operational responsibility for these is carried out by different functional units (distribution, internal audit, investment management, compliance etc).

-Log/Register

Following on from the above point it would be appropriate to consider maintaining a log or record of actions taken within the scope of the LRM Framework and amendments made (or determined not to be made following due consideration) to it. This would also assist in demonstrating not only follow on relating to issues, but constructive challenge and related interaction, as well as the element of a “live” and adaptable approach required⁶⁹. This could be included as a feature of the (required) risk register.

-Reporting

Periodic reporting is required by applicable legislation⁷⁰ and inadequate reporting was cited as one of the shortcomings identified in the CBI Letter⁷¹, noting that this is an “essential part” of the risk management policy. Accordingly, the terms of this should specify the contents and frequency of reports, their sources, inputs and addressees.

-Escalation

A key point stemming from the foregoing and one also highlighted in the CBI Letter is the need to include formal escalation procedures into the LRM Framework so that matters are promptly brought to the attention of the board outside the standard reporting cycle where appropriate.

While a specific focus of the CBI Letter, the broader issue of escalation is already a point of

guidance from the CBI, with the CBI’S Fund Management Companies Guidance - requiring designated persons to agree appropriate thresholds and KPIs which would trigger immediate escalation to the board’s of management companies⁷².

-Review

It is standard practice for most policies to be reviewed on a periodic basis, typically annually⁷³. The requirement for the LRM to be “Live” and “adaptable” implies that while periodic reviews will be necessary, a more interactive approach will be more appropriate. Market developments following market stress events, such as the Covid-19 pandemic and other “black swan” type occurrences - many of which may have unique elements or features - may necessitate tweaking elements of the framework. Accordingly, providing for a mechanism for applying revisions on an ongoing basis will need to be part of the LRM Framework. This should also be considered in conjunction with the escalation procedures to determine at what point escalation should be automatically triggered. Engaging in significant new activities should also trigger a review so the approval process for these should include consideration of any appropriate revisions to the LRM Framework.

Embedding the LRM Framework

One of the remaining challenges to be addressed is how best to integrate these elements into the ongoing working of the UCITS, including ensuring that delegates are carrying out the relevant tasks assigned to them under this overall framework. Failure to adequately address this would also be indicative of a shortcoming in the internal control framework, identified as a key shortcoming by the CBI⁷⁴. Accordingly a number of techniques to assist in this regard are highlighted below based on the LRM Guidance.

⁶⁹ See Findings 1, 6,7 and 9 of the CBI Letter.

⁷⁰ Paragraph 2 of Schedule 9 of the Irish UCITS Regulations

⁷¹ Finding 8, CBI Letter

⁷² Findings 8 and 9 of the CBI Letter.

⁷³ Regular review conducted no less than annually are required by the CBI- see, CBI “Dear Chair” Letter October 2020 for example.

⁷⁴ Finding 9, CBI Letter

-Service Level Agreements

While elements of the contractual agreements with the key delegate service providers to a fund will include obligations pertaining to their carry out of activities and provision assistance pertaining to liquidity risk management, these are likely to be relatively general and generic. Accordingly the use of service level agreements (“SLAs”) is an appropriate means of providing assurance that relevant procedures are conducted, as well as documenting this. The SLA underpinning each primary service contract should be reviewed to ensure it adequately addresses the activities expected to ensure all aspects of the LRM Framework are carried out.

-Liquidity management tools

Examples of liquidity management tools (“LMTs”) include providing for an anti-dilution levy, swing pricing or even suspensions (to the extent permitted under the UCITS legislation. It is interesting to note that increasing the availability and use of such tools was identified as one of the five priorities highlighted by ESMA⁷⁵. Adopting these will entail including specific disclosure in the fund’s prospectus, as well as formulating policies relating to the circumstances where they will be applied to ensure this is done on a consistent, systematic and impartial basis. Accordingly, these policies, as well as the related disclosures will constitute elements of the LRM Framework and should be cited in it.

-Disclosures

The need to include appropriate disclosures pertaining to LMTs in the Prospectus has been noted above, but this should also extend to the UCITS KIID⁷⁶. In addition, other disclosures pertaining to the LRM Framework should also be adequately included, for example identifying the liquidity risks in the risk disclosure section etc.

-External Controls

The necessity for adequate internal controls has already been noted⁷⁷ but attention should also be paid to external controls- which primarily relate to the role of the depositary and the auditors. The scope of the audit should be broad enough to include the LRM Framework⁷⁸. Interestingly ESMA notes a lack of checks on data quality for data from providers used for analysis purposes so this highlights the need for independent assessments to ensure it is “sounds and reliable” data, as required⁷⁹.

Summary

In summary, therefore, the LMF Framework of a UCITS should include, in addition to the risk management policy of the fund’s management company pertaining to it, a single over-arching document noting all other relevant documents (which could be included in the risk management policy), the RMP, other policies of relevance (Valuation, Distribution, Liquidity Management Tool Policy etc) and the risk appetite statement. Key elements of the LMF Framework will include not only identification of all relevant documents, but identification of all stakeholders and procedures relating to escalation, review, reporting and update requirements.

Next Steps: Timing for Actions Required

The specific obligations on Irish UCITS Management companies arising from the CBI Letter are to ensure they have conducted a documented review of relevant practices, documentation, systems and controls and approved an action plan to address any shortcomings or issues identified. It is worth again noting that this should be undertaken by reference to all aspects of the LRM Guidance and not only the CBI Letter.

In terms of timing this project is required to be completed by the end of quarter 4 in 2021 so it would be reasonable to expect a preliminary

⁷⁵ See its report “Recommendation of the European Systemic Risk Board (ESRB) on liquidity risk in investment funds” [esma34-39-1119-report on the esrb recommendation on liquidity risks in funds.pdf \(europa.eu\)](#)

⁷⁶ See paragraph 11(VIII) of the ESMA Guidance

⁷⁷ Finding 9, CBI Letter

⁷⁸ See paragraph 11(XI) of the ESMA Guidance

⁷⁹ See paragraph 11(VII) of the ESMA Guidance

report and/or project plan to be presented to boards in quarter 3, with the final report, confirmation of compliance and any proposed revisions to documentation to be presented at the quarter 4 meeting. This would ensure that any related documents can be approved at that time to ensure timely compliance. It can be noted that firms who received the CBI March Letter were subject to an obligation for their review of related matters (and for their boards to have considered and approved this) by the end of June 2021, although the full

implementation of necessary steps is also subject to the December 2021 deadline for them.

Going forward, at a more macro level, as soon as a CSA is announced by ESMA on any specific area firms would be well advised to begin taking action to ensure their relevant practices, documentation, systems and controls are reviewed and updated as necessary. The CSA currently being conducted into “undue costs” for funds is a specific example of this⁸⁰.

About the Author

Mark Browne has in excess of 20 years legal experience advising on issues pertaining to UCITS. A frequently published author and speaker regarding issues relating to the financial services industry, including UCITS in particular, he has been recommended as a leading investment funds lawyer by The Legal 500 and Chambers & Partners (Europe and Global). Previous editions of Chambers Global noted that "he garners significant praise for launching UCITS funds and ICAVs, as well as handling the relevant regulatory issues with clients describing him as "terrific: he is responsive, almost always available and knowledgeable." and reported that clients stated "the amount of attention he gave us was outstanding," praising his "knowledge of how to get the deal done, and his great end product." He is recognised as a “notable practitioner” by IFLR1000, the guide to the world’s leading financial law firms. He was previously named as ‘Investment Fund Formation Lawyer of the Year in Ireland’ in the CIM Global Awards and Investment Management lawyer of the year in Ireland by the Lawyer International 's Legal 100 awards.



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⁸⁰ See my related article for an analysis of this “Regulatory focus on fund charges”. Available at: <https://www.clerkinlynch.com/wp->