Legal Update

Irish Fund Director Association Q&A on UCITS LRMF

Board compliance with the UCITS Liquidity Risk Management Requirements

Transcript of the Q&A session between Jonathan McKeown and Mark Browne of Clerkin Lynch for the Irish Funds Directors Association in November 2021 on board perspectives on compliance with the UCITS Liquidity Risk Management requirements.

Question: What actions are required by Boards by the end of the year?

Well the specific actions required by year end depend on whether the board is a UCITS self managed investment company (SMIC) or if it has appointed a separate management company (Manco).

The requirements of the May 2021 CBI letter are addressed to UCITS managers, which will include the boards of SMICs. So in those cases the requirement will be for boards to ensure a review for compliance with that letter (and the ESMA letter as well as other items referenced therein) has been conducted and documented and to table and approve an action plan to address any updates required.

Ok – so they don't need to have implemented the changes by year end but they do need to have completed the review to ascertain what changes are appropriate- so this should be formally NOTED- and then they would proceed to RESOLVE to approve an action plan to ensure they are implemented. I would suggest that the minutes of the board meeting where this action plan is approved should be pretty detailed in order to satisfy the CBI's requirements around independence and challenge as well as to evidence proper "discussion" of the proposals as required.

Question: What kind of questions might Boards members ask as part of these discussions?

So – some of the questions that directors might consider posing might be:

- Who had primary responsibility for conducting the review – the Designated Person, the lawyers, the asset manager ?
- Have all of these parties fed into it ?
- were any objections registered to any aspect of it ?
- Have any difficulties in implementing it in practice been identified ?
- What are the likely costs of implementation (for example will new software licences be required). That seems a common theme in practice.
- Will there be additional ongoing costs as a result of implementation ? (extra hours for service providers or might the work required constitute an additional service ? etc).
- What is the likely timeline for implementation
- Who will provide the ultimate confirmation to the board that this has all been implemented ?

Question: so we have heard about SMICs and Mancos, but what about boards who have appointed a separate Manco?

Now in the case of separately managed entities their UCITS boards are not directly in scope for the specific obligations of this exercise, but as we know the CBI has issued guidance noting that ultimate responsibility for the appointment and oversight of the management company rests with the fund board, so the requirement of the fund board will be to ensure that the management company is on top of this issue. So at the very least the fund boards should be seeking confirmation of this from the management company that this is the case and then they should be documenting the fact that they Noted this confirmation had been received in their minutes.

However, to ensure they are exercising the appropriate level of oversight expected of fund boards I would suggest it would be appropriate to go beyond this. I would recommend that the board should request a formal presentation on this be given by the management company and then they should probe the matter to some

extent, request a copy of the review and action plan and ask questions perhaps along the lines of those I have outlined.

In addition, in cases where the management company is affiliated with the investment manager fund boards may wish to request some form of external and independent confirmation regarding compliance and probably should be exercising a greater level of oversight on this that would be the case if the Manco is independent from the investment manager.

Question: What should Directors be
(i) looking out for
(ii) be asking for and
(iii) expect to see in their Board packs in terms of the liquidity risk framework?

Again, this will in part be dependent on whether the fund is a SMIC or has appointed a separate management company.

Its also dependent on whether the intention is to immediately ensure full compliance with the requirements pertaining to the liquidity risk framework or just to meet the requirement to have a review conducted and to have prepared an action plan to address full compliance in the future.

So lets assume its only intended to do the minimum at this stage with full implementation to take place at a later date.
Well, regardless of whether the fund is a SMIC or has a separate Manco, the board should be seeking confirmation that the required review has been carried out and an action plan prepared to address it. I would recommend boards request a copy of this review and action plan in both cases, even though it would only need to be formally approved by the SMIC or Manco and not the board of a separately managed fund.

When the action plan is being implemented the board should be expecting to see the full framework document and mark-ups showing all changes to underlying or additional documents proposed on foot of this. So at that stage boards should expect much more substantive documentation.

Now naturally if board approval is required to update any existing documents as a result of the review, which would typically be the case, then they should be receiving draft copies of those prior to being asked to approve them.

Question: What are the key risk management framework requirements for Irish UCITS managers?

Well when we look at the criticisms made in the CBI Letter some of the key ones include the absence of a single cohesive framework – there was actually a complete lack of any clearly defined framework in many cases. They note that some funds simply sent them a bundle of documents which they said together represented the risk management framework. And this was clearly unacceptable.

So at the most basic level its key to ensure that there is a single identifiable framework document. Now this could be as simple as a table of contents that identifies the constituent parts of the risk management framework, but more likely it will include that table of contents along with a brief explanation of how the various underlying documents interact and together form the overall framework.

In terms of underlying documents that make up the framework some of the primary ones will include the:
- Risk appetite statement
- Risk management process and or policy
- And then the whole suite of relevant policies

And those documents should be reviewed for consistency with each other. They should also include cross referencing to show how they interact as part of a single cohesive framework. There are also key generic elements which each of these should contain, as highlighted in the CBI letter, to ensure they meet the standards required - such as a set escalation process, a format for recording and reporting relevant issues and a process for review under the policy and updating the policy on an ongoing basis.

Question: What other policies will be impacted by the LRM Guidance and should therefore form part of the LRM Framework?

All policies that impact on liquidity should be included in the overall liquidity framework. So its important to note that this is not just confined to investment policies of the investment manager.

So a couple of practical examples:

– the dividend policy is highly relevant because clearly if available cash is distributed out in the form of dividends this will directly impact the ability of the investment manager to meet redemption requests from cash.
- The redemption policy itself- and whats relevant here is not just how frequently a fund offers dealing days with redemptions (many UCITS are of course daily dealing but the obligation is to have at least 2 dealing days a month) but what is the time lag between a redemption request being received and the requirement to actually transfer proceeds to investors and then how does this match with settlement timings for assets held in the portfolio that may need to be sold to ensure there is cash to meet these requests.
- Its also worth taking into account the distribution policy for the fund and the make-up of its Investor base. And this is one of the examples of areas where we are seeing an interface between the requirements here and those under CP86. A fund that has a very narrow investor base with only a couple of investors is likely going to have to factor that into the liquidity risk framework because the likelihood of redemptions on a single date is probably very different for a broadly distributed fund.

So they are just a couple of examples but essentially any policy that impacts on liquidity will be relevant. And what is appropriate here is not just to include these in the framework but to ensure there is consistency between them and then that they interact with the appropriate level of cohesiveness.

Question: 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. Can you outline why it might be more appropriate for these to be separate?

Well different approaches are of course possible, but at a macro level responsibility for fund policies would typically sit with the fund board whereas processes and procedures are operational matters which would normally be the responsibility of the entity carrying them out, which in the context of the Irish funds will normally be the delegate appointed to provide relevant services such as the investment manager, administrator etc. These are of course separate legal entities.

Now it may be appropriate for there to be relevant policies at both levels- for example in the case of AML, there is a requirement for funds to have their own AML policy but in practice the policy will normally provide that they will rely on the policies in place at the administrator which is the entity actually carrying out AML checks and processing subscriptions (subject to these being compliant with applicable law). This may also be a relevant consideration here.

So lets look briefly now at the Risk Management Process or RMP specifically. So this is a document that was first required as a result of the UCITS III reforms permitting use of derivatives by UCITS for investment purposes. And those of us who worked on the first iterations of the RMP will recall that in most cases it was often a very brief document in part because most existing UCITS confirmed that they were not going to use derivatives for investment purposes. As some of these launched new sub-funds with different strategies or objectives that changed and we also saw the launch of the so called “newcits” that took a more active approach to the use of derivatives.

Over the years the content and requirements pertaining to the RMP have become more elaborate and apart from primary legislative requirements we have seen further guidance on these from ESMA and from the CBI, for example in the CBI UCITS Q&As. These documents have to be filed with the CBI and in fact the CBI now even has a specific form – UCITS Application Form 13 – addressing these and specifying some of the requirements they need to contain.

I think that there may also have been a tendency to include some items in the RMP that were not strictly required to go there but it was not clear where else they might best be documented.

Now the requirement to have an RMP lies with the Manco if a separate Manco has been appointed (and this is specifically noted in the CBI Q&As because it seems the ESMA Q&A may have caused some confusion on this point) but one specific reason why fund boards might want to consider having a separate risk management policy from the risk management process is because if there is a separate management company then the risk management policy of the UCITS itself could also address how the UCITS board oversees the UCITS management company.

There are various other practical and legal considerations around this point but this is I think a really key one, it goes back to the who guards the guards maxim. I won't cite the latin for this !. But I think this point is becoming increasingly important in practice as obviously in the post Brexit environment we have seen increasing numbers of asset managers setting up boots on the ground here in Ireland and these typically include their own UCITS Mancos or SuperMancos. which they staff not just with distribution personnel, which was often a key rationale in them setting up in Ireland, but of course also with the required risk and management personnel to carry out general management functions and risk oversight.

So these are of course separate legal entities to the underlying asset manager but they will be part of the same group and I think this type of structure places perhaps a greater onus on UCITS directors to probe the practical application of the oversight function and ensure the Manco is indeed acting independently.

Question: What actions have been taken by clients following the CBI review?

The main approach has been to conduct an analysis of the requirements in the CBI letter, along with the ESMA public statement and other documents referenced there, and then to conduct a gap analysis of what they have been doing to date and what they need to do to ensure full compliance.

Typically that will involve updating the documentation, including adding cross referencing and perhaps putting it within a specific framework, as wel as adding some additional policies and procedures- but in some cases will also involve additional steps such as implementing new software tools such as Liquidity Risk Metrics from MSCI.

Question: how are clients positioned as the deadline looms?

Well I think we can divide firms into different categories.

The third party Mancos seem to be generally very well prepared themselves but of course they have to adapt their templates and processes to apply to each individual underlying investment manager and fund so in terms of actually implementing the framework there is typically some work to be done and of course some firms are still seeking to move across to them to comply with CP86.

The large fund houses that have their own Mancos in Ireland seem to typically be well prepared because of course it would be reasonable to expect fairly close co-operation between the Mancos and their affiliated companies. But this may flag other issues which we will discuss later.

I think some of the smaller SMICs who are still planning on moving to a separately managed model are less prepared as they anticipate that this will all be addressed as part of the move, but the investment manager will still need to interface with the Manco to agree elements of this on the move.

The 20% of managers who were contacted directly by the CBI immediately after they conducted the initial review will generally have fully implemented the review and even adopted appropriate updated procedures as a result of the direct contact with the CBI.

Question: Failure to conduct pre-investment forecasting was a key criticism of the CBI.

Yes. that was the specific focus of 2 of the 9 findings in the CBI letter and impacts on some of the 7 others to various extents.

This aspect seems to have been a primary focus among managers when seeking to address the requirements of the CBI Letter, in part because it may have necessitated implementation of additional operational steps.

In practice, while implementing this may entail further work, it seems likely that it will primarily generate an issue where a manager has been seeking to invest in slightly more esoteric assets which perhaps were on the borderline in terms of them constituting eligible assets. Generally speaking, the primary assets UCITS will be investing in, such as large cap US equities for example should not overly give rise to concerns in this regard because data packages and software can be acquired to assist in meeting the relevant forecasting requirements.

However, some areas where these obligations may prove more problematic may include thinly traded securities, perhaps including emerging market equities or loans. As we know the Lux regulator has prohibited UCITS from investing in this latter category although they have been permitted in Ireland. It seems that probably the largest mainstream asset class where the forecasting requirements may pose an issue is likely to be fixed income securities.

In any event the requirements in this regard have been clarified so boards will need to get comfort from underlying investment managers that they do have the relevant tools and are applying them.

Question: Are there any common issues clients are facing & how are they being resolved?

Yes. One issue that is cause for concern among third party Mancos is getting buy in from investment managers regarding the interpretation of liquidity for their portfolios. This can be a source of debate and friction especially where the approach a manager wishes to use diverges from standardised approaches (eg. bid-ask spreads, impact analysis)

The corollary of this is that for UCITS that have a Manco and investment manager from the same group there is perhaps a greater impetus on fund boards to ensure that the Manco can stand over the model it is using and that it has not been overly influenced by the preferences of the investment manager in this regard.

So from a board perspective I believe that this is an area to probe and it’s a good way of demonstrating the challenge expected by the CBI of board members. Now no one size fits all so just because different funds are applying different approaches it doesn’t necessarily mean any of them are wrong but I would recommend boards explore why approaches were taken to ensure they can be justified and ensure they are comfortable that the approach is reasonable in the circumstances. Where board members can see a range of approaches taken across the funds they work with they may wish to compare these and explore reasons for any such differences.

Question: Are we to expect another LRM review by the CBI next year? If so, what will it look like?

Well lets look at the background to the LRM review. This was undertaken in 2020 as part of a common supervisory action or CSA coordinated and driven by ESMA. It was in fact

the largest such CSA undertaken to date and involved all inscope Irish UCITS managers requiring them to provide quantitative portfolio level breakdowns of each their UCITS – over 3,000 funds in all. Each of these was subject to detailed analysis and 20% of the managers were subject to in-depth investigation and direct feedback. So it was a really major undertaking that has already identified the managers where the key concerns arose.

Its also worth noting that the CBI had already and separately issued Dear CEO letters on related matters in August 2019 and April 2020 due to concerns related to Brexit and Covid-19 respectively.

Furthermore ESMA has identified new priority areas for scrutiny which are the subject of the next CSA – one of those is for “undue costs” . Now I have prepared an article focusing on this so if people would like to receive it they can contact me directly or its available on our website at Clerkin Lynch to be downloaded.

So bearing all this in mind - while the CBI has said that this will continue to be an area of supervisory focus - I think its unlikely we will see a further LRM review by the CBI next year.

What we may see is a request for confirmation that boards have addressed this along with some isolated spot checks and potentially some further guidance, especially if it becomes apparent that a portion of the market has addressed this in a manner the CBI considers is inadequate.

However, this was a landmark exercise and the CBI has noted in its Dear Chair letter of May 2021that going forward in the course of any future supervisory engagement it will have regard to the manner in which this issue was addressed. So just because funds don’t get a knock on the door, so to speak, next year doesn’t mean that the issue has gone away. And this really underlines the need to ensure that the whole review process undertaken as a result of this is adequately documented and can be produced in future years if required.

Question: How can directors evidence implementation?

Well the Central Bank has said that their first action where they are reviewing a fund for general compliance will be to review the past board minutes. So directors would be well advised to ensure the minutes show them noting and approving the review, discussing it in relevant detail and then approving the action plan.

The minutes should also show the directors noting the implementation of the action plan in due course and approving any document updates required further to this. So those elements will be prima facia evidence of implementation.

But the subsequent board packs should also contain ongoing reporting to the directors under this risk management framework and then these minutes should show evidence of oversight and challenge from them on it on an ongoing basis.

For further information in relation to this topic please contact the author detailed below.

Contact and Further information

Author Biography

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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