

NEW  
ORGANISATIONAL  
REQUIREMENTS  
FOR UCITS  
MANAGEMENT  
COMPANIES  
UNDER UCITS IV

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## New organisational requirements for UCITS Management Companies under UCITS IV

### Introduction

UCITS IV<sup>1</sup> introduces significant changes for UCITS management companies which will need to be addressed well in advance of the end June 2011 start date. In particular, through the UCITS IV Implementing Directive<sup>2</sup>, new MiFID like organisational and internal control requirements, conflicts of interest requirements and risk management requirements will be applied to UCITS management companies. In addition, UCITS management companies will need to comply with new rules of conduct.

In advance of finalisation of a revised set of UCITS Notices and a revised Guidance Note 04/7, this paper outlines the key changes coming down the track and discusses the impact which they are expected to have on UCITS management companies and how they carry on and control their activities.

Note that the focus of this paper is on collective portfolio management not individual portfolio management.

### Source and Rationale

The Implementing Directive of July 1, 2010 contains the level 2 measures relating to the organisational requirements for UCITS management companies under UCITS IV. The Implementing Directive must be introduced by Member States by end June 2011.

The new organisational, internal control and other requirements under the Implementing Directive seek to align the UCITS and MiFID regimes to a significant extent, with the aim of achieving equal standards between different financial sectors and, at a micro level, within asset management businesses.

Two key themes running through the Implementing Directive are the protection of the end investor and market integrity. When one considers the new rules of conduct in particular, it is clear that an examination will need to be made by management companies of existing class structures within UCITS schemes as well as looking at matters such as costs applied to UCITS to ensure that duties towards end investors are complied with. In other words, this is not simply a process for reorganising procedures and implementing new controls, it goes much further than that.

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<sup>1</sup> Directive 2009/65/EC

<sup>2</sup> Directive 2010/43/EC

In many cases, the provisions of the Implementing Directive are quite prescriptive, setting out in considerable detail specific requirements, the controls that need to be put in place relating to those requirements and upon whom obligations are imposed. Whilst these provisions are quite focused on procedures and controls, it is important to remember that their purpose is ultimately to protect the end investors. That needs to be at the forefront of any consideration of how and why one changes one's procedures in light of the UCITS IV requirements.

The new requirements will impact all UCITS management companies, whether they operate on a fully delegated basis delegating out administration, investment management and distribution activities or whether they retain, for example, administration and delegate out investment management and distribution.

Self-managed investment companies are equally affected by these new requirements and all references in the Implementing Directive to management companies should be read as also being a reference to self-managed investment companies.

In addition, the new requirements will impact boards of UCITS management companies and of self-managed UCITS investment companies which currently operate on a collective responsibility basis as it is envisaged that it will now be a requirement within a UCITS business plan and organisational structure to name specific individuals as being responsible for specific duties.

## Proportionality Principle and Delegation

The Implementing Directive recognises the principle of proportionality. In other words, the application of most (but not all) of the requirements of the Implementing Directive must be proportionate and must take into account the different nature, scale, and complexities of UCITS management companies.

Factors which may be relevant in determining the extent to which the proportionality principle should apply may include the number of UCITS managed, number of sub-funds within umbrellas, the extent of use of derivatives or of complex trading strategies, number of investors.

The Implementing Directive also recognises UCITS management companies should be able to delegate some of their activities to third parties provided proper due diligence checks are carried out to ensure the third party is qualified.

In many cases, therefore, UCITS management companies will seek to meet their obligations by ensuring that their delegates meet the requirements of the Implementing Directive. Ultimate responsibility for ensuring that they do so, however, rests with the management company.

This may require additional controls to be placed over delegates, reviews to be carried out of service provider contracts and reconsideration of reporting lines, access to information and capacity to verify.

## General requirements

Article 4 of the Implementing Directive imposes general requirements on UCITS management companies to have adequate internal organisation and control mechanisms, clear reporting lines and assignment of responsibilities. Other requirements imposed are to protect confidentiality, the security and integrity of information and the requirement to ensure adequate business continuity policies. The principle of proportionality and the recognition of the ability to delegate, as highlighted above, are applicable.

Management companies will need to consider the proportionality principle and how it applies to their business. They will need to take into account the nature, scale and complexity of their business which will focus on the types and complexity of UCITS they manage, the number of UCITS and sub-funds they manage, the number of investors they have and the number of markets they sell into.

Whilst many of the requirements should not require a fundamental change to the existing governance and internal control mechanisms, new procedures will need to be adopted to meet the requirement to protect confidentiality, the security and integrity of information and to ensure adequate business continuity policies.

In addition to preparing new procedures and update their business plans, management companies will need to look at their service provider contracts to ensure that, through their delegates and their delegates' procedures, they meet the requirements.

## Resources

Article 5 of the Implementing Directive requires UCITS management companies to employ "personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them" and to carry out due diligence on delegates. As

highlighted above, the Implementing Directive recognises that UCITS management companies should be able to delegate some of their activities to third parties, provided proper due diligence checks are carried out and delegates are monitored.

Whilst reference is made to a requirement to “employ personnel”, we do not believe that a formal employment obligation will be imposed nor that a minimum number of employees will be required. Again, the proportionality principle applies.

We think that what is likely to develop in practice is the delegation of duties to individual board members (often from the promoter group) who will be responsible for performing the relevant duties with support from executives within different functions of the promoter group or to employees on the ground in Ireland or to specialist service providers via secondment or similar arrangements (or a hybrid of the above).

## Complaints

Article 6 of the Implementing Directive requires UCITS management companies to establish, implement and maintain effective and transparent procedures for complaints handling. UCITS management companies must ensure that each complaint and the measures taken for its resolution are recorded, that investors are able to file complaints free of charge and management companies must make information regarding complaint handling available to investors free of charge.

Management companies may need to examine at what level, and where in the overall organisational structure, complaints arise, in particular, where they arise or are notified at distributor level in local markets. Management companies will need to understand the complaints process at local market level, how complaints are dealt with, how promptly they are dealt with and may require regular reporting from distributors. In that context, distribution arrangements may need to be reviewed.

## Electronic data processing, record keeping and other recording requirements

The Implementing Directive requires UCITS management companies to ensure timely and proper recording of each portfolio transaction and of subscription and redemption orders. In addition, UCITS management companies will be required to ensure appropriate safeguards are put in place to ensure that electronic data processes are secure and that the integrity and confidentiality of recorded information in respect of the UCITS is maintained.

Articles 14 and 15 of the Implementing Directive, respectively, set down the requirements for recording portfolio transactions and for recording subscription and redemption orders.

Article 16 imposes detailed record keeping obligations in a similar manner to the requirements under MiFID. For example, it requires UCITS management companies to ensure the retention of certain records for a period of at least 5 years and to store that information in an accessible form for future reference by the competent authority of the Member State.

These requirements are not anticipated to cause significant changes to the current operation of management compliance companies. However, as the Implementing Directive sets out a series of a specific minimum requirements as to what those records must contain as well as for how long they need to be maintained, management companies will need to examine with investment managers/custodians current trade transaction recordkeeping and, similarly, subscription and redemption transaction recordkeeping with transfer agents to ensure that, at a minimum, the Implementing Directive's requirements are met both in terms of content and period of record retention.

## Accounting procedures

We do not believe that any material changes need to be made in relation to the valuation process requirements as they relate to the valuation of assets and liabilities of the UCITS, the calculation of the NAV and the application of the NAV to the subscriptions and redemptions.

Whilst some update may be required to the business plan in terms of disclosure, one point that is worth noting is that the Implementing Directive includes an express provision that, from an accounting perspective at least, all assets and liabilities of a UCITS must be directly identifiable at all times. The precise rationale behind that statement remains unclear as one would think that that would be a practical necessity anyway in terms of the NAV calculation process.

## Control by senior management and supervisory function

Article 9 of the Implementing Directive requires reinforced oversight duty by senior management in respect of delegated service providers.

Senior management (which can include directors) must receive on a frequent basis, and at least annually, written reports on matters of compliance, internal audit and risk management, investment policy and strategies indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies. On a regular basis they must also receive various other written reports relating to the discharge of those functions.

Directors of Irish UCITS management companies normally receive such reports already. It is not anticipated to cause significant changes to the current operation of management companies.

## Compliance function, internal audit function and risk management function

To ensure that a UCITS management company has an adequate control mechanism, Articles 10, 11 and 12 of the Implementing Directive require a permanent compliance function, internal audit function and a permanent risk management function respectively for UCITS management companies. These requirements are, however, subject to the proportionality principle and we expect that the respective compliance, internal audit and risk management functions within the delegates (administrator, investment manager and distributor) will primarily be relied upon, with perhaps increased reporting to the UCITS management company.

Subject to further guidance being issued by the Central Bank, we expect that the Compliance Officer function could be undertaken by a director (regardless of where that director is located) with substantive support from compliance personnel within the promoter group, or by an employee or secondee or other service provider located in Ireland.

## Exercise of Voting Rights

UCITS management companies will be required to develop adequate and effective strategies for determining when and how voting rights attached to instruments held in the UCITS' portfolios are to be exercised, to the exclusive benefit of the UCITS concerned.

Article 21.2 provides that the strategy for the exercise of voting rights shall determine measures and procedures for monitoring relevant corporate events, ensuring that the exercise of voting rights is in accordance with the investment objectives and policies of the relevant UCITS and preventing or managing any conflicts of interest arising from the exercise of voting rights.

Common within fund complexes in North America, the formalisation of procedures concerning the exercise of voting rights has become a topic on the agenda of many European fund groups over the last number of years and, in fact, we have advised several funds clients in relation to the preparation of such procedures quite recently.

These procedures generally identify the occasions where votes will be exercised and where they will not, and explain clearly how the exercise of voting rights will only be exercised in the interest of the relevant collective investment scheme and its investors, rather than those of the promoter/investment manager group.

## Personal transactions

Article 13 of the Implementing Directive builds upon the EU Market Abuse Rules<sup>3</sup> and requires UCITS management companies to identify and record relevant person's personal transactions and to ensure the notification and recording of personal transactions to the management company. UCITS management companies must also ensure that proper preventative measures are put in place to seek to any potential breaches by individuals of the Market Abuse Rules.

This requirement is not currently imposed on Irish UCITS management companies under UCITS III<sup>4</sup> so they will need to amend their organisational procedures accordingly.

## Conflicts of interest

Articles 17 to 21 in Chapter III of the Implementing Directive extends the provisions under MiFID, which requires investment firms to identify, manage and disclose their conflicts of interest, to UCITS and their management companies. The Articles impose three separate grounds for consideration by UCITS management companies which may need to amend their organisational procedures accordingly.

Firstly, UCITS management companies will need to adopt a written policy which will (a) identify when potential conflicts will arise and in doing so, they will need to consider the

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<sup>3</sup> Directive 2003/6/EC

<sup>4</sup> UCITS Management Company Directive (Directive 2001/107/EC) and the UCITS Product Directive (Directive 2001/108/EC), the Management Company and Product Directives referred to generally as "UCITS III".

implications of group entities; and (b) set out the procedures to be followed and measures to be adopted in order to manage such conflicts. Again, the proportionality principle applies.

Secondly, the Implementing Directive requires UCITS management companies to design those procedures to ensure that relevant persons engaged in different business activities involving a conflict of interest carry on those activities at a level of independence appropriate to the size and activities of the management company and of the group to which it belongs and to the materiality of the risk of damage to the interests of clients.

In this regard, the Directive set outs several requirements to be implemented (where necessary and appropriate for the management company) to ensure the requisite degree of independence including to:

- (a) establish procedures to prevent or control exchange of information where this may lead to a conflict of interest when this may harm one or several clients;
- (b) establish separate supervision processes for the persons whose principal functions involve the portfolio management or the provision of services for clients or investors whose interest may conflict;
- (c) remove any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity where a conflict of interest may arise in relation to those activities;
- (d) establish measures to prevent or limit any person from exercising inappropriate influence over the way in which a relevant person carries out collective portfolio management activities; and
- (e) establish measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate collective portfolio management activities where such involvement may impair the proper management of conflicts of interest.

Where these measure or any one of them does not ensure the requisite degree of independence, alternative or additional measures and procedures as are necessary and appropriate should be adopted.

Thirdly, the Implementing Directive requires that a record of the types of collective portfolio management activities leading to conflicts of interest entailing material risk of damage must

be kept. If a UCITS management company cannot ensure that a conflict of interest can be prevented, the senior management or other competent internal body should be promptly informed in order to take the necessary decision to ensure that the management company acts in the best interest of the UCITS and its investors.

UCITS management companies will be required to consider how conflicts may arise and take into account group relationships, they may need to appoint key senior individuals with responsibility for supervision of persons such as portfolio managers where conflicts may arise and for considering instances where conflicts may not be preventable.

UCITS management companies may also need to re-consider existing remuneration policies, both intra-group and potentially within delegates.

## Rules of conduct

The rules of conduct are broadly grouped into four main areas, namely, the duty to act in the best interests of UCITS and their unitholders, the duty of UCITS management companies to ensure a high level of diligence on the selection and monitoring of investments in the best interests of the UCITS they manage, reporting obligations in respect of execution of subscription and redemption orders, and best execution and order handling rules.

Article 22 is entitled "Duty to act in the best interests of UCITS and their unit-holders" and provides that management companies must ensure that unit-holders of managed UCITS are treated fairly. It also requires that management companies must refrain from placing the interests of any group of unit-holders above the interests of any other group of unitholders.

Article 22 also requires management companies to ensure that fair, correct and transparent pricing models and valuation systems are used for the UCITS they manage, in order to comply with the duty to act in the best interest of unitholders, and management companies will be required to act in such a way as to prevent undue costs being charged to the UCITS and its unitholders.

Additionally, management companies are required to apply appropriate policies and procedures for preventing mal-practices that might reasonably be expected to affect the stability and integrity of the market.

The second part of the rules of conduct Chapter deals with due diligence requirements concerning the investment process, with Article 23(1) requiring management companies to ensure a high level of diligence in the selection of and ongoing monitoring of investments,

again in the best interest of UCITS and the integrity of the market. Adequate knowledge and understanding requirements are imposed as are requirements to establish written policies and procedures on investment due diligence and on the risk management process.

Whilst the investment related due diligence obligations are likely to arise normally at investment manager level, UCITS management companies will need to not only supervise their investment management delegates but also ensure that their delegates have the adequate knowledge and understanding of the assets in which the UCITS are to be invested (and a procedure to ensure compliance with that requirement). Management companies will also be required to establish written policies and procedures on due diligence and will be required to implement effective arrangements for ensuring that investment decisions on behalf of the UCITS are carried out in compliance with the objectives, investment strategy and risk limits of the UCITS.

Importantly obligations of due skill, care and diligence are imposed on management companies when entering into, managing or terminating any arrangement with third parties in relation to the performance of risk management activities.

Additionally, specific reporting obligations in respect of execution of subscription and redemption orders (method of notification and timing thereof) will require checking with the fund administrator to ensure its processes meet the listed requirements.

Whilst matters such as best execution, order handling, order aggregation etc. can be readily dealt with within the provisions of asset management contracts (and in fact, in many cases, are already dealt with in those contracts), the requirement to ensure that investors are treated fairly, the obligation not to place in the interests of one investor group over another and the obligation to prevent undue cost being charged to UCITS and to end investors will require management companies to review the class structures and cost structures of their funds.

Our expectation is that in most, if not all cases, management companies will be able to justify (and document) their existing class and costs structures but this is an area that will need to be examined in some detail.

## Best Execution and Order Handling

MiFID type best execution rules will be applied to UCITS management companies by virtue of Article 25 of the Implementing Directive. Management companies will be required to take all reasonable steps to obtain the best possible result for the UCITS, taking into account

price, costs, speed, likelihood of execution and settlement, order size and nature, or any other consideration relevant to the execution of the order. Further prescriptive details are set out in the Article as regards the relative importance of such factors.

In addition, the Directive also clarifies that clear that best execution requirements relate to the choice of the executing broker as well as the choice of the execution venue.

Given that these are MiFID type best execution rules with which European asset management groups will already be familiar with and subject to, we do not believe that these rules should create difficulty for a UCITS management company. However, particular attention may need to be paid to the best execution obligations under contractual arrangements with non-EU investment managers to ensure that UCITS IV best execution obligations are complied with.

Order handling rules and rules relating to the aggregation and allocation of orders are set out in Articles 27 and 28, respectively.

## Inducements

Article 29 of the Implementing Directive prohibits a UCITS management company from receiving fee and commission payments as well as non monetary benefits in relation to the activities of investment management and administration, except if:

- (a) paid or provided to or by the UCITS or on behalf of the UCITS; or
- (b) paid or provided to or by a third party (other than the UCITS); or
  - if appropriate disclosure;
  - if enhancement of the quality of the service;
- (c) proper fees (fees which enable or are necessary for the provision of the relevant service, including custody costs, settlement and exchange fees, regulatory levies or legal fees, and which by their nature, cannot give rise to conflicts with the management company duty to act in the best interests of the UCITS).

Importantly, where a UCITS management company pays or is paid any fee or commission or provides or is provided with any non-monetary benefit other than those listed above, it shall

not be regarded as acting honestly, fairly and professionally in accordance with the best interests of the UCITS.

Management companies may need to examine existing fee arrangements to ensure these provisions are complied with.

## Miscellaneous

Article 38 requires UCITS management companies to establish, implement and maintain an adequate risk management policy as further detailed in the Directive. Irish UCITS management companies are already required comply with certain guidelines relating to risk measurement and the calculation of global exposure and counterparty risk.

In relation to the risk arising from financial derivatives, this is not anticipated to cause significant changes to the current operation of such companies.

The risk management procedures for other aspects of a management company's business, may require further consideration.

## Conclusion

As detailed above, a number of aspects of the Implementing Directive will require that a number of the aspects of the operation of the business of Irish UCITS management companies are enhanced and procedures strengthened as further detailed above. In all cases, it is expected that a revised business plan will be required to be filed with the Central Bank.

**Date:**                **December 2010**

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