UCITS – Organisation of Self-Managed Investment Companies

Matheson

Introduction

This note highlights the key organisational requirements that apply to UCITS established as self-managed investment companies ("**SMICs**") and the means by which compliance should be documented.

A UCITS structured as an investment company or Irish collective asset management vehicle ("**ICAV**") may appoint a management company or it may operate on a self-managed basis. A SMIC must comply with many of the same authorisation requirements as management companies. It is possible for an investment company / ICAV which has a management company to subsequently convert to a SMIC, or for a SMIC to subsequently convert to an externally managed investment company / ICAV and appoint a management company.

There are a number of reasons why a fund promoter would choose either the SMIC structure or the management company structure, and the principal reasons are summarised below.

Capital
A UCITS management company is required to have minimum capital of €125,000, or three months' working capital expenditure. If its assets under management exceed €250m, it is required to have additional capital equal to 0.02% of the additional capital, up to a maximum of €10m. This capital requirement is ongoing, cannot be invested in the funds under management and must be held outside the group. In contrast, a SMIC is only required to have initial capital of €300,000, which must be provided by the fund promoter prior to authorisation, but which can be redeemed on receipt of the equivalent amount of capital from shareholders when the UCITS commences trade.

Ongoing Costs
A management company is required to have a board of directors and a company secretary, to prepare annual audited financial statements and to pay an annual levy to the Central Bank of Ireland ("**Central Bank**"). This creates an additional layer of expenses for a fund promoter that represents an ongoing cost. Any such costs must be borne by the management company and cannot be passed on to shareholders in the UCITS, other than by the management company charging the investment company a management fee. The investment company will also have equivalent expenses, so there is effectively a double cost where a UCITS is externally managed and a single layer of costs where the UCITS is a SMIC. The shareholders in the investment company (whether externally managed or a SMIC) can bear these ongoing costs on behalf of the investment company.

Passport
A management company authorised in one EU member state can passport its services into another member state. This means that an Irish management company may act as manager of a UCITS domiciled in another EU member state and it will not be necessary to establish a second management company in that other jurisdiction. A SMIC cannot manage other UCITS.

Delegation
SMIC and management companies can delegate functions relating to administration and investment management to MiFID authorised or Central Bank approved investment managers and administrators.

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Authorisation Process

Both SMICs and management companies are required to comply with the Central Bank's organisational requirements for UCITS, which require the adoption of a business plan detailing how the management functions of the SMIC or management company will be performed. This is essentially a regulatory compliance plan which allocates responsibility for the management function between the directors and details the reporting they will receive from service providers. It will also detail the various policies and procedures which the company has adopted. The Central Bank has confirmed that, whilst SMICs are required to maintain detailed operating procedures covering certain areas identified by the Central Bank, the business plan is not required to include or incorporate detailed operating procedures manuals. The business plan should, however, include a description of the policy in relation to those areas, with cross references to the relevant procedures.

Each director of the SMIC must complete and submit an Individual Questionnaire ("**IQ**") to the Central Bank prior to authorisation of the SMIC.

Key Management Functions

In accordance with good corporate governance principles, the Central Bank considers that the board of a SMIC is responsible as a whole for the following managerial functions, each of which must be specifically addressed in its business plan.

Each SMIC is required to review the regulatory obligations placed on it and should identify precisely under which managerial function each regulatory obligation falls. The Central Bank's guidance sets out a suggested framework for the allocation of regulatory obligations to the different managerial functions. Each management company may however attribute specific regulatory obligations to the managerial function deemed most appropriate.

The managerial functions and related procedures are as follows:

- **Capital and Financial Management:** procedures to ensure it meets its capitalisation requirements, to ensure all relevant accounting records of the SMIC are properly maintained and are readily available, including production of annual and half-yearly financial statements; and that the board adequately oversees the proper and accurate valuation of the assets and liabilities of the SMIC;
- **Operational Risk Management:** the monitoring of the business of delegates to ensure they are effectively managed and controlled, and that appropriate operational risk policies and procedures of the delegates are in place;
- **Fund Risk Management:** procedures to ensure that all applicable fund risks pertaining to the SMIC are identified, monitored and managed at all times;
- **Investment Management:** procedures to review and approve the proposed investment approach of any new sub-fund of the SMIC, and, on an ongoing basis, to oversee the investment manager's compliance with the approved investment approach, and developments affecting the investment manager(s), the investment process and strategies, the investment team and progress and performance;
- **Distribution:** the approval of proposed distribution strategies of the SMIC, and ongoing monitoring of patterns of distribution, sales flows and any local compliance issues connected to the funds' distribution; and
- **Regulatory Compliance:** procedures and an organisational structure which specify reporting lines and allocates functions and responsibilities to ensure compliance with all regulatory obligations.

One director of the SMIC is additionally required to perform an organisational effectiveness role. This director must be independent and may not carry out any of the managerial functions. The role is to keep the effectiveness of the SMIC's organisational arrangements under ongoing review. The director is required to bring proposals to the board to improve effectiveness, champion these proposals and ensure that agreed actions are implemented.

Responsibility, Delegation and Review

Responsibility

Although the boards of SMICs have collective responsibility for managing its affairs, individual "**designated persons**" must be identified for each of the above managerial functions. A designated person is responsible for monitoring and overseeing the managerial function assigned to him or her. Designated persons may be directors of the SMIC, or may be seconded to the SMIC from another firm (eg, the investment manager) or from a third party firm which specialises in the provision of designated persons. Designated persons may be located globally, provided at least 3 of the managerial functions are performed by at least 2 designated persons resident in the EEA (or such other jurisdictions as the Central Bank may determine).

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Delegation

SMICs are entitled to delegate functions, provided that adequate measures are put in place which enable it to monitor effectively, at any time, the activity of the undertaking to which the function in question has been delegated. Such measures are intended to ensure that SMICs do not become mere "letter box entities". In addition, it should be noted that, notwithstanding delegation, responsibility for the key managerial functions will remain at all times with the relevant designated person (and ultimately with the board as a whole).

Furthermore, it should be noted that the Central Bank requires the board of the SMIC to take all major strategic and operational decisions affecting the SMIC (subject always to any matters reserved to its shareholders). Examples of key responsibilities that should be retained by the board include the following:

- approval and periodic review of the business plan and compliance with it;
- its own internal governance, including the appointment and retention of directors and conflict of interest policies;
- adoption and review of a comprehensive suite of policies and procedures and, to the extent that reliance is placed on the policies and procedures of delegates, periodic review of the appropriateness of such reliance; and
- satisfying itself that arrangements are in place to enable compliance with applicable legal and regulatory requirements.

These retained obligations are generally understood to be obligations of oversight and review of functions, rather than requirements to undertake the functions directly and it is assumed that the SMIC may delegate the performance of the underlying functions.

One of the key controls which SMICs have over their delegates is the requirement for them to report regularly on their areas of responsibility. The business plan must set out the reporting frequencies and lines between the delegates and the relevant designated person, which shall include but not be limited to exception reports, in line with thresholds and triggers determined by the board from time to time and specified in the business plan. The business plan must also specify the procedures to be adopted by the board on receipt of reports.

Review

SMICs are obliged periodically and on an ongoing basis to assess and review the effectiveness of the policies, arrangements and procedures which have been put in place to comply with their regulatory obligations and to take appropriate measures to address any deficiencies. This requirement applies to the SMIC's own policies but also to the policies and procedures of delegates. More specifically, the Central Bank requires that business plans mandate service level agreements and KPI reporting, a detailed annual review of each delegate and mechanisms for reporting material issues to the board, with subsequent review to ensure controls are in place to prevent reoccurrence and the imposition on delegates of an obligation to attend board meetings of the SMICs where material issues arise.

Risk management

The SMIC must establish, implement and maintain an adequate and proportionate risk management policy which:

- identifies and addresses all of the material risks which have been identified, with a particular emphasis on market, liquidity and counterparty risks and collateral management;
- confirms the risk appetite;
- addresses the tools and techniques used for the management of the risks;
- allocates responsibilities within the SMIC for risk management;
- addresses reporting requirements of the risk management function; and
- provides for regular reviews and assessment of its adequacy and effectiveness and that of the statement of risk management procedures, the compliance of the SMIC with the policy and the effectiveness of measures taken to address deficiencies in the policy.

A hierarchically and functionally independent "permanent risk management function" must be established by the SMIC with the requisite authority and access to fulfil its role. The risk management function may be provided by a third party, although this delegation will itself be subject to the review, resourcing and reporting requirements described above. The primary role of the risk management function is the implementation of the SMIC's risk management policy but additional tasks may include ensuring funds' compliance with risk limits, advising on the risk profile of funds and supporting the valuation of over-the-counter financial derivative instruments.

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Conduct of Business Rules

SMICs are required to put in place formal conduct of business rules that the SMIC must observe at all times, although some of the rules can be considered in terms of proportionality. These obligations are derived directly from provisions of the Irish legislation implementing the UCITS Directive or are conditions imposed by the Central Bank, and include the following:

General Principles

- Duty to act in the best interests of UCITS and their unit-holders
- Due diligence requirements

Best Execution

- Execution of decisions to deal on behalf of the UCITS
- Placing of orders to deal on behalf of UCITS with other entities for execution

Administrative and Accounting Procedures

- Electronic data processing
- Accounting procedures

Inducements

- Safeguarding best interests of UCITS

Handling of Subscription and Redemption Order

- Reporting obligations in respect of execution of subscription and redemption orders

Administrative Procedures and Control Mechanism

- Safeguarding best interests of UCITS

Conflicts of Interest

- Criteria for the identification of conflicts of interest
- Conflicts of interest policy
- Independence in conflicts management
- Management of activities giving rise to detrimental conflicts of interest

Strategies for Exercise of Voting Rights

Handling of Orders

- Procedures and arrangements which provide for the prompt, fair and expeditious execution of portfolio transactions
- Aggregation and allocation of trading orders

Internal Control Mechanisms

- Control by senior management and supervisory function
- Permanent compliance function
- Permanent internal audit function
- Permanent risk management function
- Personal transactions
- Recording of portfolio transactions
- Recording of subscription and redemption orders
- Record-keeping requirements

SMICs may avail of the concept of proportionality with respect to certain management functions discussed above. This enables a SMIC to take into account the nature, scale and complexity of its business and the nature and range of services and activities undertaken in the course of that business (eg, the number, size and investment strategies of the sub-funds that it manages) in determining how certain key management functions (including compliance, internal audit, risk management and conflicts of interest) will be addressed both operationally and in the business plan.

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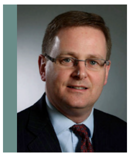
Please get in touch with your usual Asset Management and Investment Funds Group contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this briefing note.

Full details of the Asset Management and Investment Funds Group, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team, can be accessed at www.matheson.com.

Contacts

Tara Doyle
PARTNER
D +353 1 232 2221
E tara.doyle@matheson.com



Michael Jackson
PARTNER
D +353 1 232 2219
E michael.jackson@matheson.com

Dualta Counihan
PARTNER
D +353 1 232 2451
E dualta.counihan@matheson.com

Joe Beashel
PARTNER
D +353 1 232 2101
E joe.beashel@matheson.com

Anne-Marie Bohan
PARTNER
D +353 1 232 2212
E anne-marie.bohan@matheson.com

Shay Lydon
PARTNER
D +353 1 232 2735
E shay.lydon@matheson.com

Liam Collins
PARTNER
T +353 1 232 2195
E liam.collins@matheson.com

Philip Lovegrove
PARTNER
D +353 1 232 2538
E philip.lovegrove@matheson.com

Elizabeth Grace
PARTNER
D +353 1 232 2104
E elizabeth.grace@matheson.com

Oisin McClenaghan
PARTNER
T +353 1 232 2227
E oisin.mcclenaghan@matheson.com

Michelle Ridge
PARTNER
T +353 1 232 2758
E michelle.ridge@matheson.com

Barry O'Connor
PARTNER
T +353 1 232 2488
E barry.oconnor@matheson.com