



DUE DILIGENCE REQUIREMENTS EMPHASISED UNDER UCITS IV

Laven Legal Services Ltd publishes a white paper on the onerous requirements for Luxembourg regulated companies to assess and monitor their selected service providers.

Luxembourg management companies need to urgently review due diligence practices

Within the UCITS legal framework, Luxembourg regulated management companies outsource some important activities for which they remain responsible in the eyes of the law and the CSSF. This may include accounting or administration with one or more banks as well as distribution activities. This clearly results from article 110(1)(f) of the law of 17 December 2010 (previously article 85 of the law of 20 December 2002).

To understand and to be able to monitor the outsourced activities accordingly, regulated management companies must review the way they do business, not only to be compliant with the law but also to protect themselves from the impact of operational failures. This includes the risk of claims for negligence as well as reputational risk. It is important for the directors and conducting persons of regulated companies to remember that legally they have the ultimate responsibility for all delegated activities, as it is stated in the same article 110(2) mentioned above.

Under UCITS III, and before the impact of the 2008 financial crisis, it was common for management companies in Luxembourg to rely on the regulated status or brand recognition of the third parties they worked with. Companies did not feel the need for in-depth due diligence, notably in terms of covering operational risks. In addition they would rely on the reporting received from the same third parties as evidence of monitoring. This reporting alone, however, falls short of providing the proper checks as was demonstrated during the Madoff fraud.

As the industry faces new rules, as well as a tougher regulator and scrutinising investors, this is a good time for regulated companies to plan ahead and review any due diligence process they are using. We will look at the changes that are impacting operations, we will suggest processes for due diligence so that it meets the right standards without imposing too many new administrative costs.

The New Rules

European legislators have included, as part of the UCITS IV directives, the need for a robust risk management process integrating, beyond the traditional market risks, business and operational risks. The 2010/43/EU Directive implementing the 2009/65/EU UCITS IV Directive states in its section (4) that management companies should notably perform due diligence in order to determine whether any third party performing an outsourced activity can be considered as

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qualified and capable of undertaking the functions in question. The UCITS IV Directive will also be supplemented in many respects by the AIFM Directive which also touches, in a similar way, on other regulated financial companies such as custodians and managers of Special Investments Funds (“SIFs”) (as per the draft bill amending the SIF law, currently submitted for approval to the Luxembourgish parliament).

The rules remain broad and should be of concern for all regulated companies. To date there is little by way of guidance on how operational risk should be managed, although the Association of the Luxembourg Fund Industry (“ALFI”) has summarised the following “best practice measures” to assist in monitoring outsourced functions for management companies. They recommend breaking down the process into three main phases for third party due diligence:

1. **The Initial Phase** – the stage during which all delegations should be subject to appropriate due diligence prior to the delegation of the activities.
2. **Ongoing Monitoring** – this stage requires that the board of directors of the management company ensures that an effective ongoing monitoring program is in place for all outsourced functions.
3. **The Termination Phase** – the stage during which the management company must decide whether to bring the function back in-house, appoint a new delegate, or discontinue the function.

Below we provide operational ideas on how management companies and other regulated companies can adopt a process to meet their obligations and to reassure their investors that they have the financial, technical and staff resources required for the provision of their regulated services.

The Laven View

Having a long and established expertise in due diligence we believe that there are some solutions to complying with the legal obligations related to third party assessments and controls, that need not be too onerous and which will add value to the services provided by Luxembourg regulated companies. The key to due diligence is the end result, namely the reliable and demonstrable selection and monitoring of third party service providers. To make this workable it takes:

1. a set process which details the items that must be reviewed (including scope and depth) and how it will compare matters identified as against best practice standards; and
2. the investment of time so that the process can be done in full.

In practice the difficulty lies in setting out a process that will work for third parties that provide different services for which best practice standards may vary. The good news is that there are no particular prescriptive processes and no EU regulator has set in stone what they expect financial institutions to do in detail, only in terms of general practices and ethics. The expectations of the regulator will be high but this principles based approach is likely to be a good thing as it gives regulated companies freedom to determine their own standards and to promote themselves to investors as leaders in the field of operational risk management.

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Establishing a process

Once you have followed our suggested step one and written out a process and you are able to match it to a standard, you must apply it with consistency and be sure to follow step two and record what is done in order for senior management to review and approve the same. This approach will make your due diligence reliable and you will also inherit internal efficiencies as you compare various service providers in a robust and similar manner. The other benefit is that thanks to your chosen process it will be much clearer what the responsibilities of your team members or external consultants are and what kind of reporting will be produced for senior management. The downside is that this work will be costly in terms of human hours. In the end though, with proper reporting in place your work will be verifiable by the regulator and investors which should raise your profile in the industry and help raise and maintain investor confidence as times get tough.

Applying the process

How to deal with the impact of time is a major concern and one that is likely to worry the industry as it leads to more potential costs. During a typical due diligence, we can spend as much as 150 hours and rarely less than 100 hours inclusive of onsite visits. Ongoing monitoring in this context will probably take around 100 hours a year. We have the benefit of various experts who know their subject and they also have a very defined coverage which helps save time although it may be broader in scope and depth than what certain companies, in particular management companies, might require under the Luxembourg risk management policy requirements. The solution for time management lies in establishing a process that takes into account compliance with the rules and regulations. We estimate that the implementation of processes to meet the new regulatory and investor expectations will cost about one quarter of the annual working hours of a senior employee. This would provide coverage for about three third party service providers broken down as follows:

- Initial check prior to entering relationship or when renewing relationship:
100 hours multiplied by three = 300 hours
- Ongoing monitoring with quarterly reviews and a renewed end of year report:
70 hours multiplied by three = 210 hours

This time estimate does not include the time it might take to prepare senior management reports, which would cover certain aspects of focus from the due diligence reports, senior management reports should be designed to ensure senior management has carefully reviewed relevant risks highlighted in the due diligence reports. This can also be done by way of detailed minutes to protect the members of the board as much as show compliance with the fiduciary activities of the directors.

To outsource the costs will vary greatly depending on whether you use a recognised big four auditor or a niche specialised due diligence consultant. Annual costs may differ greatly and this is very hard to gauge for obvious reasons. They will depend on the scope of work you will wish to cover or whether you will necessitate the service provider to put a process in place for you or simply rely on their full discretion to produce due diligence reports.

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Staffing Due Diligence

It is extremely difficult to staff due diligence work. Relevant persons must be experienced not just in the subject matter but in the technicality of what due diligence work requires. Most companies will have a few individuals involved in general operations and some will also benefit from an accounting department and in-house counsel. If so, such companies can define at senior management level the degree of oversight that is reasonable and formulate the type of reporting on operational practices in relation to service providers that meet the right standards. The company can add to its resources by assigning a share of responsibility to specialists notably in relation to compliance or risk management so that the specialists can help formulate reports and alleviate the responsibilities of those in the company who are ultimately accountable to the regulator, including senior management.

A Potential Process

A potential due diligence process for a service provider could be broken down as follows within the confine of the scope and depth approved by senior management:

1. A predefined list of questions for the outsourcing company being reviewed.
2. A predefined list of documents that pertain to the operations being reviewed.

From the documentation, the team should independently complete as much as it can the predefined list of questions. Any gaps must be identified for further questioning, which will either take place in writing or through direct interactions. Areas of expertise should be referred to the right team members/specialists and this usually covers areas such as accounting/valuation procedures or legal issues of liability including in relation to compliance, asset protection or anti-money laundering activities.

Once the team has provided as much as it can from the documentation, it has in effect carried out a great deal already and the work could stop there. At this level, what would have been done is an operational review akin to the well known SAS 70 Type I review. This means that the processes of the third party provider have been reviewed although not tested. From the way the law is drafted, it is not possible to affirmatively deem this level of due diligence to be sufficient. It would certainly go a long way towards complying with regulatory obligations. Another step of analysis, like the type of analysis performed on any due diligence which is more akin to SAS 70 Type II reviews, would be preferable. This would test and measure the controls in place and could be done as follows:

1. A verification of all assertions made in response to questions, through corroboration from relevant documents.
2. An onsite visit to take place in the context of a pre defined agenda, with independent interviews of relevant personnel.
3. The finalisation of any last questions and a right to answer on any issues identified for the service providers being reviewed.

This format would be more complete and would guarantee compliance with rules and regulations as well as provide the utmost reassurance for senior management. It would be hard to say that

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anyone in charge of overseeing such processes had not acted reasonably in protecting investors against the potential defaults of service providers.

Once the above initial process has been completed, the law suggests that the controls are regularly monitored. That is in effect a review of the above controls on a regular basis. We would recommend ongoing monitoring is carried out on an annual basis but the law is silent on this. Generally this can be done with quarterly checks and we would advise on an annual visit to the relevant service providers with appropriate notes being kept all the way through to back up any regulatory checks that may be done later and to protect against any potential future claims from investors.

With this in mind any regulated company will be well armed to face the more demanding requirements and should be able to stand out as a leader in operational due diligence and benefit from more institutional investors' interest.

Laven Legal Services Limited is an international law firm specialised on the fund industry. We bring together a unique set of knowledge and experience spanning across a range of services such as structuring and fund formation, tax, regulatory compliance and corporate advice.

Should you wish to discuss any of the above with us, please do not hesitate to contact Kaltrine Balaj (*Conseiller juridique au Luxembourg*) at +44(0)2075944973 or kaltrine@lavenlegal.com.

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