association of the luxembourg fund industry

guidelines

Considerations for the Management of Operational Risks Associated with the Distribution of Funds

in association with ALRiM LUXEMBOURG

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EU regulation, as implemented in Luxembourg, inter alia, as the Law of 2010, the Law of 2013, CSSF Regulation 10-4 and CSSF Circular 12/546, has focused attention on the requirement for management companies pursuing the activity of management of a UCIs, either UCITS or AIF, and investment companies that have not designated a Management Company (Self Managed SICAV) to have in place an adequate Risk Management (RM) function that is proportionate to the business conducted by those companies and the risk profiles of the funds which they manage.

Such RM function is required to establish, implement, and maintain an adequate and documented risk management policy which identifies all the material risks that the funds' management companies or investment companies or its funds are or could be exposed to, including, inter alia, all operational risks that may be relevant for each fund they manage.

The aim of this document is to present to Board members and senior management those areas that they may wish to consider when looking at the management of Operational Risks associated with the Distribution/Marketing of funds and when the developing their RM functions by:

- Highlighting the key sources of legal and regulatory guidance in relation to RM in order to get a common understanding thereof; and
- Outlining a potential approach to:
    - The identification of relevant operational risks associated with Distribution/Marketing to which the Funds and/or their ManCos are or may be exposed;
    - The measurement and management of these identified operational risks; and
    - The reporting with regard to these risks and related information to senior management and the Board by the RM function.

As Luxembourg is a global distribution hub specialising in the cross border distribution and marketing of funds into multiple jurisdictions around the world consideration must also be given to the specific laws and regulations of each non-EU country into which the funds are offered for sale.

There is no exact definition of the terms 'Distribution' and 'Marketing' which would cover a uniform definition throughout all different fund types. Moreover, the terms 'Distribution' and 'Marketing' are often used without being distinguished in detail and thus subject to different interpretations, differing in addition in various jurisdictions.

While the UCITS Directive refers to but does not define the concept of 'Marketing', it nevertheless provides some indication in relation thereto. In the recitals it is stated that the UCITS Directive applies to UCIs that promote the sale of their units to the public in the Community. Furthermore, article 3 of the UCITS Directive provides that it does not apply to UCITS "which raise capital without promoting the sale of their units to the public within the Community or any part of it.
In the AIFMD, 'Marketing' is being specifically defined as: the direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the Union.

Overall 'Marketing' may be understood as the promotion of sale of units or shares of a given fund to the public. It may be regarded as the building up of commercial distribution channels.

Overall 'Distribution' may be understood as the process of collecting orders from investors and, as the case may be, placing those subscription and redemption orders with the transfer agent of a given fund for execution and providing other steps and processes associated with assisting investors to purchase shares in funds.

In this respect, for the purposes of this document, 'Marketing' may be regarded, in some cases, as part of the Distribution process and hence, the term 'Distribution' will be used as the more generic term designating Distribution as well as Marketing throughout this document

Throughout this document the term 'ManCo' will be used to refer to a management company/AIFM or a self managed investment company where no management company has been designated.

In relation to risk management a number of laws and regulations have been issued on European and Luxembourg level. In the table below, please find a brief overview of this framework including a non-exhaustive list of the key laws and regulations related to risk management.

Legislation and Regulatory Framework for Risk Management		
	European Union	Luxembourg
Level 1 legislation	Directive 2004/39/EC (MiFID)	Law of 5 April 1993 on the financial sector, as amended
	Directive 2009/65/EC (UCITS)	Law of 17 December 2010 on Undertakings for Collective Investment (2010 law replaces the 2002 law)
	Directive 2011/61/EU	Law of 13 July 2013 on Alternative Investment Fund Managers
Level 2 implementing measures	Commission Directive 2010/43/EU	CSSF Regulation No. 10-4
	Delegated Regulation EU 231/2013	
Level 3 guidelines	CESR* Guidelines 09/178	CSSF Circular 11/498
	CESR* Guidelines 10/788	CSSF Circular 11/512
	ESMA Guidelines 2011/112	CSSF Circular 12/546
Upcoming Legislation	Directive 2014/65/EU (MiFID II)	To be transposed into Luxembourg Law by 3 July 2016Applicable as of 31 December 2016
	Regulation (EU) No 1286/2014 (PRIIPS)	

** predecessor to ESMA*

The additional guidelines listed below are also relevant best practice documents, which may be considered for the implementation of an operational risk framework.

‘Best Practice Proposals for the Organisation of the Risk Function of a UCITS Management Company or UCITS Investment Company’

‘Guidance Paper for the Risk Monitoring of Functions Outsourced/Delegated by a Management Company or Investment Company’

‘Best Practice Proposals for the Management of Operational Risks within UCITS Management Companies’

ALFI Guidelines: ‘Risk Management under the Alternatives Investment Fund Managers Directive’

These guidelines, produced by the ALFI Technical Committee, seek to provide a set of best practices that the Boards and senior management of ManCos may wish to consider when developing, or reviewing the adequacy of, their RM functions and considering the risk monitoring of delegated functions.

There are also many other sources of information and guidance, including:

	Industry Guidelines
Best practice guidelines in other industries	• Principles for the Sound Management of Operational Risk, issued by the Basel Committee in June 2011 • The Compendium of Supplementary Guidelines on implementation issues of operational risk issued by CEBS/EBA September 2009

This document will focus specifically on the identification, measurement, monitoring and reporting of risks associated with the Marketing and Distribution of Funds (Distribution Risk).

Distribution Risk is not specifically defined in the Law or CSSF regulation, however the responsibility of the Board and senior management of a ManCo is to consider all the risks to which the Funds they manage are exposed. Therefore they need to assess also those risks that may arise from the Marketing and Distribution of the funds.

The requirement for a formal coverage of Operational Risks for ManCos is derived from the UCITS Directive and the Commission Directive2010/43/EU as well as the Luxembourg CSSF Regulation N° 10-04. According to Luxembourg regulation, the Risk Management Process (RMP) with respect to UCITS should comprise procedures necessary to assess "… the exposure of the UCITS to all other risks, including operational risks, which may be material for each UCITS it [the ManCo] manages."

An AIFM is also required to monitor operational risk under Article 15 (2) of AIFMD and Articles 38-45 of the AIFMD-CDR.

CSSF Circular 12/546 (clause 7.1.4) requires that every use of an external service provider must be preceded by written due diligence by the management company on the provider. In the context of this requirement of diligence, the management company must, amongst others, identify the operational risks deriving from this delegation. While the Circular 12/546 is written to be specifically applicable to UCITS ManCos, the CSSF has advised that their expectation is that all AIFMs will also comply in principle with substance and control standards laid down in the Circular. In this context, recital (51) of the AIFMD-CDR can be cited which emphasises that in the interest of consistency, AIFM's risk management function tasks and responsibilities should be similar in nature to those assigned by Commission Directive 2010/43/EU to the permanent risk management function in UCITS management companies.

1. Distribution Risk embedded in the Operational Risk Management

Operational risks arise in the whole value chain of an asset management firm – typically clustered in the three parts for which the UCITS ManCo is responsible; investment management, administration and marketing. As regards the AIFMD, the European legislator has explicitly named two core functions; portfolio management and risk management, for which an AIFM is responsible. However in practice AIFMs are often party to the administration and depository agreements and are responsible for valuation which means that they have to closely monitor these functions as well.

Such risks will be mitigated by internal control processes within the operational policies and procedures which the ManCo has in place and which they apply to the daily operations of the ManCo. Service Providers should have equivalent policies and procedures that are in line with the internal control standards set by the ManCo.

All controls put in place at the operational functions/team – be it internally or at the level of the service providers – constitute the first level of defence.

Risk Management (RM) and Compliance act independently of operational functions and constitute the second level of defence.

The RM function is responsible for the design, implementation and ongoing development of the operational risk framework and has to ensure that adequate policies and procedures do exist. All parts of the business are exposed to forms of operational risk and a risk management framework therefore needs to be embedded across the business to be fully effective.

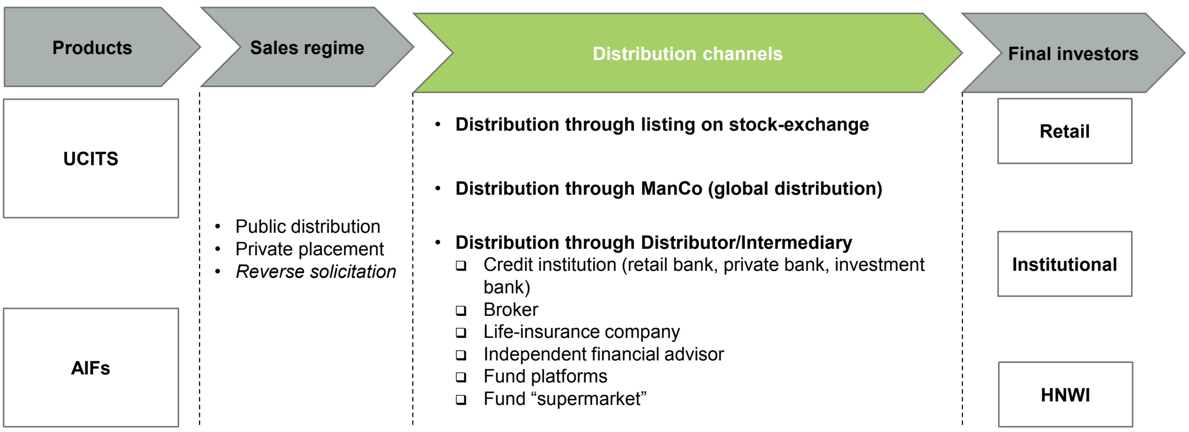
Later in this document we will look at examples of the Distribution risks that are relevant to ManCos and the funds that they manage and we will consider the mitigating controls that may be put in place.

2. Overview of distribution models and channels

While ManCos may establish direct distribution channels to their final customers/target investors (global distribution model), distributors will often be used as intermediaries in order to channel the sales/ marketing efforts. The type of Distributors used may differ according to the distribution practices in the target geographical market (cultural, regulatory, tax aspects), the target investor category (for example: Retail, Institutional or High Net Worth Individual) and the type of product/strategy marketed.

The following chart provides an overview of the distribution channels which may be used for the distribution of investment funds. The identification and measurement of the risks associated with the distribution activity need to be adapted to the distribution model implemented by the ManCo. Although the Fund/ManCo liability might be different depending on the type of distribution channels they use their approach to assess and manage operational risk may be the same across all models. The Fund/ManCo should define their distribution policy to cover the governance rules and principles around the use and appointment of distributors, the types of distributors used, distribution channels to be accessed, use of group and/or third party companies, the geographical and jurisdictional locations into which distribution will be made.

Marketing of AIFs by the AIFM will bring additional complexity and risks. While under the UCITS directive the UCITS as a product has a passport to market into other jurisdictions the AIFM directive gives the passport to the AIFM and not the AIF. Specifically the AIFM will need to consider the risks it faces in appointing suitable distributors/placing agents, pre-marketing procedures that may be carried out before an AIF is registered and the risks of selling on a reverse solicitation basis.

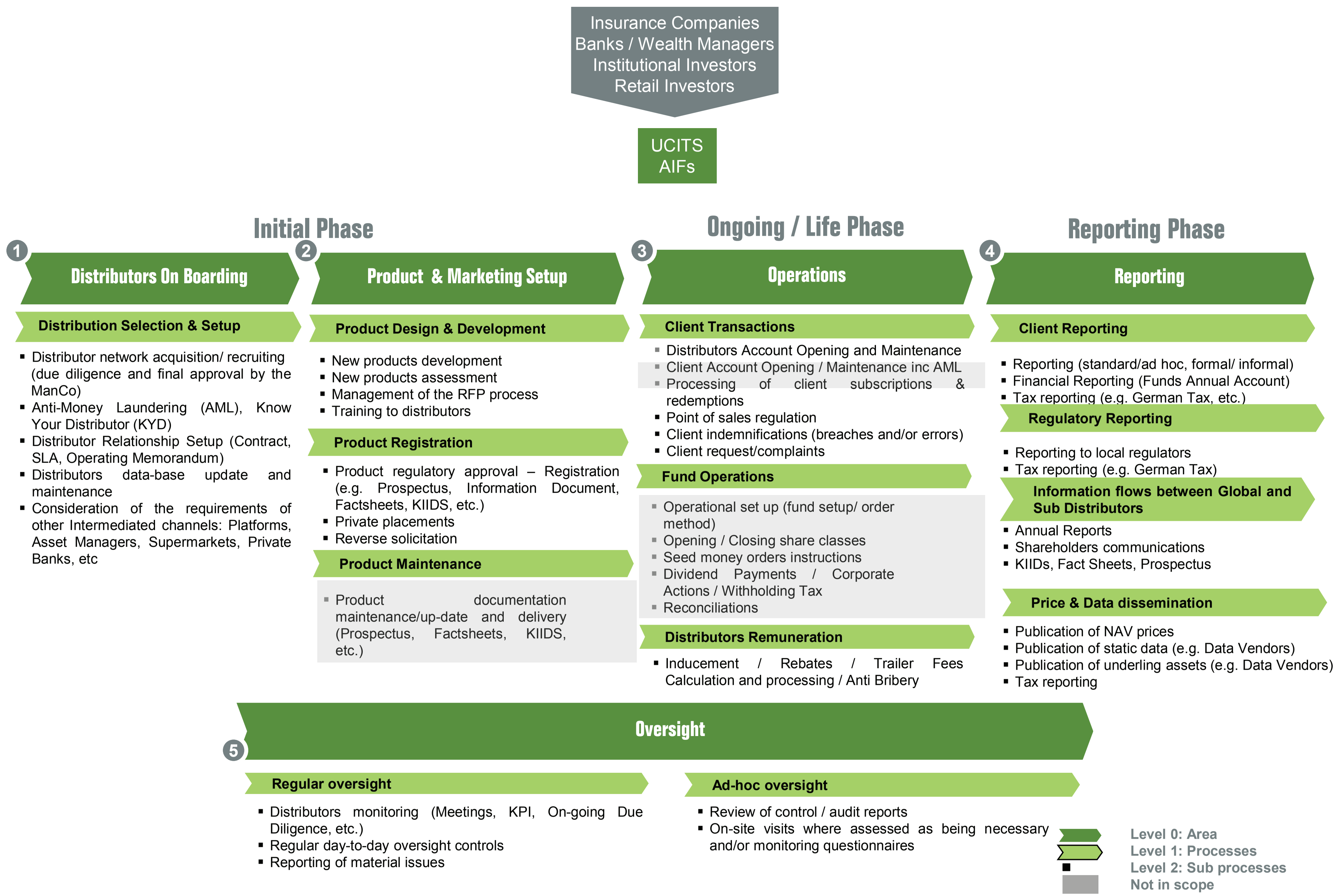


3. Categories of Distribution Operational Risk

In considering where operational risks may arise in the process of distributing and marketing funds we have identified five primary process flows which will give rise to potential risks which need to be identified, measured, monitored and reported.

These process flows may be categorised as outlined in the diagram below. This document will not cover all of the processes but rather provide examples that the management of a ManCo may wish to consider in developing their oversight of Distribution Risk.

Global Distribution Process Flow



a. Distributor On-Boarding

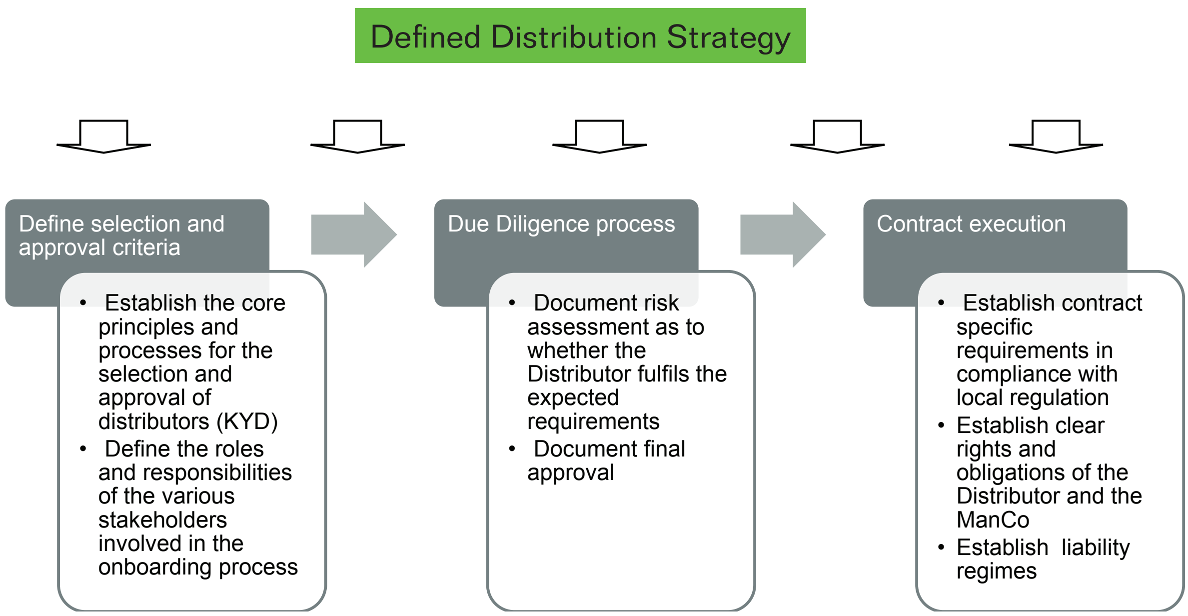
In this flow the risks associated with the acquisition and on-boarding of distributors who wish to distribute the funds managed by a ManCo in a single or multiple jurisdictions should be considered. It is critical to select distributors that best fit into the ManCo's distribution strategy with the least amount of operational risks (e.g. misselling).

The implementation of Know-Your-Distributor procedures is a fundamental element of the distribution on-boarding process since it supports the identification and measurement of inherent risks related to the distributor. It is important to understand that to select a best fit this exercise has to go beyond a pure Anti Money Laundering (AML) and Know Your Client (KYC) assessment.

For ManCos providing third party services to funds the selection of the distributor, and/or sub-distributors, is often initiated by the sponsor/initiator of the fund. The ManCo must be satisfied that due diligence has been adequately performed and that the approval of the distributor remains with the governance structure of the ManCo.

Consideration should also be given to the risks associated with using other intermediated distribution channels such as Platforms, Supermarkets, Private Banks, Asset Managers, etc. The diagram below presents a high level description of actions to be considered to mitigate operational risks when on boarding distributors.

Distributor on-boarding



b. Product and Marketing Setup

There is increased focus by regulators on the governance of product development, the sale of products to target markets and the potential for the misselling of products. This attention is likely to increase with the implementation of MiFID II and PRIIPS. While some of this focus will not necessarily fall on ManCos, there are potential risks that may arise as a result of the interaction between product manufacturers and the distributors, for example where training is given to distributors, in the production and distribution of fund documentation (Prospectuses, KIIDs, Factsheets, Marketing Material, etc.) and in ensuring that products are properly registered before they are offered for sale. Additional risks may be encountered if products are not registered and reliance is being placed on private placement or reverse solicitation processes. In considering the potential risks the requirements of the host country and/or regulator must be taken into consideration.

c. Operations

There are a number of operational processes in relation to the distribution and marketing of funds that may give rise to operational risks. Under these processes consideration should be given, among others, to the risks associated with; the calculation and payment of Inducements (Rebates, Trailer fees, Commissions, etc.) to distributors, the indemnification of clients from the impact of investment breaches and NAV errors and the receipt, recording and handling of client complaints.

d. Reporting

Consideration needs to be given to the potential risks that may occur in four key areas where reporting is normally provided to distributors and end investors.

1. Client Reporting and Disclosure

This may take the form of standardised reporting or in response to ad hoc requests from clients. Inaccurate reports may give rise to the risk of claims for damages, reputational risk and potentially regulatory risk where the information is used for clients to submit returns to their domestic authorities. Client reporting will also embrace the preparation and provision of documents such as; Annual Report & Accounts for funds and the requirement for tax reporting in a number of jurisdictions. AIFMD also brings other challenges such as ensuring that marketing material is consistent with the fund offering documents and that appropriate disclosure is made in accordance with the transparency and disclosure requirements of the Law (articles 20 & 21).

2. Regulatory Reporting

The reporting requirements to regulators have, and are continuing to, expand dramatically under a range of new regulations. Where these specifically impact the distribution processes, such as Solvency II, MiFID II, they may involve multiple sources of data and significant manual intervention in order to complete the reporting leading to the potential for significant Operational Risks that need to be considered and managed.

3. Information Flow between Global and Sub-Distributors

The Global Distributor, often the ManCo, will be responsible for the provision of various fund information to the Sub-Distributors who in turn will provide these to the end investors. The Global Distributor must ensure that controls are in place and effective to gain comfort that the information is accurate, current and provided to all recipients at the same time. Specific regulatory requirements exist around the format, content and updating of Key Investor Information Documents (KIID) while claims for miss-selling may arise if documents such as factsheets are inaccurate or misleading. Controls around the communication of corporate actions on funds, e.g. AGM/EGM notices, Dividend payments and updates to Fund Documentation, etc., must ensure that they are made in a timely and accurate manner.

4. Price and Data Dissemination

Fund prices are distributed normally based on the NAV frequency of the fund (often daily) to numerous users of the data. This will include; investors, platforms, intermediaries, data vendors, newspapers, etc. Operational risks arise from potential delays in distribution resulting in, for example, the publication of stale prices and platforms/ intermediaries being unable to update their systems and produce contract notes and/or statements for the end investors. It is also the practice to provide fund static data information and fund information to various data vendors with the inherent risk of incorrect information being provided.

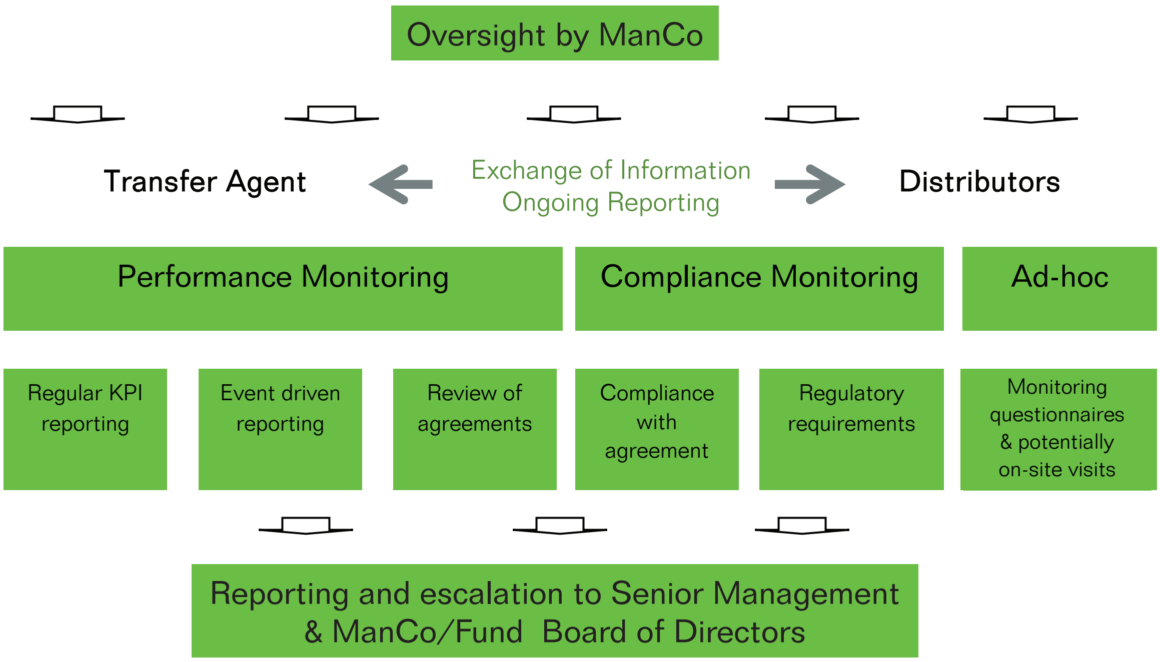
e. Oversight

Oversight is an on-going process covering the whole Distribution Process Flow. Risks arise from the lack of, or inadequate, oversight of distributors and other service providers involved in the distribution process and the internal control processes around distribution. It is the responsibility of each ManCo to consider the most efficient way to perform their oversight depending on how the risks associated with different distribution models, different jurisdictions and distributors are risk assessed.

Firms should consider whether oversight can be adequately performed remotely and under what circumstances it may be appropriate to conduct onsite visits to distributors. In addition ineffective escalation and reporting to senior management and the Board will compound the risks.

The diagram below presents an example of an oversight framework to be considered when monitoring distributors. See additional details in the KRI section of this document.

Oversight framework



ManCo and Fund Boards are responsible for defining the risk appetite of the business and ensuring that the operational risk framework is implemented fully and efficiently.

The RM function is responsible for the design, implementation and ongoing development of the operational risk framework and has to ensure that adequate policies and procedures exist. The distribution of funds leads to exposure to forms of operational risk and a risk management framework therefore needs to be embedded across the business to be fully effective.

In fact, operational risks are primarily managed at business levels by having implemented defined processes and related internal controls (1st line of defence). The specific structures used by organisations may differ with some deciding to have specialist functions to control, for example, the on-boarding of distributors, separately from Sales or other Operational areas. These control focused functions remain part of the Level 1 controls within the business but provide useful information and support to the overall RM function.

Below are some examples of the types of risks related to distribution of a fund that senior management of the ManCo may wish to consider when developing their internal controls and RM function and the RMP. While these operational risks are relevant to ManCos and funds, each ManCo will need to assess the likelihood of these risks arising based on the operating model of their company or the company(ies) to which they are providing third party services and, where appropriate , that of their service providers.

Examples of Distribution Risks	Examples of Mitigating Controls
Distributors On Boarding	
• Inadequate and/or incomplete due-diligence • Delegation to distributors not covered by a signed legal agreement • Distributors do not fulfill their responsibilities with regard to AML/KYC checking • Failure to comply with regulatory requirements when defining Distributors remuneration • Processes and control environment of distributor do not match the requirements of the ManCo in practice	• Documented and approved Distributors Risk Assessment Policy • Due diligence procedures over distributors • Process for verifying completeness of distribution agreements • Distribution agreement includes liability clause (e.g. capped), applicable law and competent jurisdiction, conflicts of interest, handling of complaints, data protections, use of third parties, etc.) • Approval of Distributors by the ManCo
Product & Marketing Setup	
• Inadequate or incomplete assessment of distribution capability for new products • Failure to register/notify funds/share classes in a jurisdiction before starting to market the Funds • Failure to comply with host country marketing regulations/material requirements • Inadequate training to distributors • Reliance on Reverse Solicitation for sale of products	• Establishing process for keeping abreast of key changes in local regulatory requirements, and ensuring proper follow up where necessary • Establishing contact with local regulators / advisers where necessary to clarify understanding for significant areas which are unclear • Establishing a training monitoring programme • Establishing a process for legal analyses and obtaining comfort over practices per relevant jurisdiction

Operations	
• Non-compliance with host country point of sales regulatory expectations and/or market practices • Non-compliance with appropriate inducement regulations in different jurisdictions • Errors in the calculation of the remuneration • Client Complaints not handled in accordance with regulations • Suitability/Appropriateness obligations are not completed by distributors • Failure to monitor for suspicious transactions • Acceptance of trading that may contravene Market Timing regulations	• Documented procedures covering the regulatory requirements of each host country into which funds are distributed • System enforced validation and/or 'four eyes' checking, of remuneration calculations • Management review of all client complaints independent of Sales and Operational functions • Initial due diligence and on-going monitoring of distributors policies and procedures related to selling of funds • Monitoring of subscriptions and redemptions for suspicious transactions or late trading. Management approval of excemptions
Reporting	
• Incomplete or misleading information presented to the investors in standard reports • Incomplete or misleading tax reporting related to investors (e.g. OECD tax common reporting standards) • Investors are not provided with the latest Fund documentation or notices • Late delivery of NAV prices to distribution platforms • Incomplete or misleading information published on website to investors • Late and/or inaccurate trade confirmation sent to investors • Incomplete, or inconsistent with fund documents, marketing material	• Establishing a process for verifying accuracy and timeliness of information made available to investors • Establish relevant KPIs and exception reports for timely follow up in the event of operational issues • Establish a process for the review and approval of marketing material
Oversight	
Lack of relevant information to perform adequate oversight over distributors, service providers involved in distribution process	Establishing the key information flows and timings which are a prerequisite to carry out proper level of oversight, and implementing these in agreements where applicable, to ensure they are available
Conflicts of interest may arise when oversight is being performed over distributors and service providers which are part of the same group as the Management Company	Ensuring that there is a process for identifying and managing such conflicts in an appropriate manner
Lack of adequate Oversight framework	Set up an ongoing due diligence/monitoring framework for Distribution activities
Lack of information and lack of cooperation of business partners	Establish due diligence questionnaires and track regular completion by Distributors Establish regular communication with Sales Department to strengthen business and client relationship

V. tools to assist with the assessment, monitoring and tracking of distribution risks for funds

When looking into the Distribution risks that are relevant for each fund, the risk management function will need to define respective measurement, which may not necessarily be quantitative and monitoring approaches for each risk category based on an analysis of the risks in the operational processes applicable to each process. They will need to consider whether appropriate, and effective, mitigating controls have been identified and implemented in the ManCo, or its service providers, procedures in order to control the identified risks.

The RM functions should then consider what independent monitoring needs to be put in place to ensure that these controls are working and that timely escalation and reporting is taking place.

Below you will find examples of how a – simplified – documentary overview of risk measurement and monitoring approaches for the Distribution and Marketing functions may look. The methodology used for the identification of the risk type categories, the assessment of the risk frequency and the estimated severity, shall all be detailed and documented.

It would be good practice to document all relevant operational risks in a similar manner.

Risk Category		Identified Risk Type	Approach to measurement of risks	Entity/ department performing measurement of risks	Tool/ system used to measure risks (if any)	Appraoch to limitations of risks	Entity/ department responsible for monitoring of risk limitations	Frequency of monitoring of risks	Approach to remedial actions (i.e. Escalation of breach limits)
Operational risks	Marketing (Distribution	Delegation to Distributor not covered by a Legal Agreement	Due diligence conducted on distributor before on-boarding	Risk based due diligence completed by sales function or dedicated team with support from Legal and Compliance department as necessary		Specific authorised signatures only allowed to sign agreements	Client on-boarding department within the ManCo	At time of each client on-boarding	Escalation to senior management of any request to on-board a client without a legal agreement
			Agreement that meets ManCo standards used for all distributors	Legal department to review appropriateness of the agreement		Approval processes for allowing non-standard clauses, or deletion of clause, from agreements			
			Legal review and signing of the agreement by a duly authorised person	Operations to ensure agreement signed before opening an account on the ManCo systems		Regular refresh of due diligence process with the distributor depending on the level of risk assessment			

Risk Category		Identified Risk Type	Approach to measurement of risks	Entity/ department performing measurement of risks	Tool/ system used to measure risks (if any)	Appraoch to limitations of risks	Entity/ department responsible for monitoring of risk limitations	Frequency of monitoring of risks	Approach to remedial actions (i.e. Escalation of breach limits)
Operational risks	Product & Marketing Setup	Failure to register/notify funds/share classes in a jurisdiction before marketing the funds	Establish Country registration Matrix for funds/ share classes	Compliance or Operational Risk teams	Sales Front end tools	Zero tolerance for breaches	1st level controls Sales/ TA	Ongoing on Business unit level	Ad hoc exception to Conducting Officers
					Sharholder register	Policy that limits sales activities to the list of registered Funds	Compliance Department	Ad hoc controls by Compliance	Regular Distributor oversight reporting to Conducting Officers and Management Board
			Check against Sales documentation of marketing activities			Upload Fund registration list in Sales Front end tool	Conducting Officers	Monthly review Conducting Officers	
						IT codes in TA systems to allow only transactions from countries where the funds are registered	Internal Audit reviews		
					Funds Static Data database				
						Ongoing ex post controls			
			Regular comparison of client register (country of residence) with fund registration matrix						

Risk Category		Identified Risk Type	Approach to measurement of risks	Entity/ department performing measurement of risks	Tool/ system used to measure risks (if any)	Appraoch to limitations of risks	Entity/ department responsible for monitoring of risk limitations	Frequency of monitoring of risks	Approach to remedial actions (i.e. Escalation of breach limits)
Operational risks	Operations (Distribution)	Incorrect Client compliant handling	Regular Review of Client Complaint log Receipt by ManCo of relevant client complaint details from distributors Number of complaints Aging of complaints Complaint trends Serious complaints	Transfer Agency Client Services or other client facing departments	Spreadsheet or other IT tools like Client relationship management (CRM)	Complaint handling Procedure considering local complaint requirements in markets where Fund is registered/ distributed (response time limits) Ex post assessment of complaint severity and if complaint was closed in line with the process (required timelines)	1st level controls Compliance Department	Ongoing Business Unit level	Regular reporting process to Conducting Officers and Management Board of the ManCo Escalation of serious complaints

1. Key Risk Indicators (KRI)

A set of well-defined KRI is one of the starting points for a proper identification, assessment, reporting and management of operational risks. Specific requirements for the flow of information between the fund manufacturer – distributors – fund manufacturer will become clearer under the implementation of MiFID II and, in particular, the Product Governance and Target Markets sections. These will allow firms to consider in more detail what it is appropriate to measure, escalate or provide reporting on through KRI. Many of the key risks that exist in the distribution network should also be considered in the due diligence procedures where a clear metric is not available or clearly measureable.

a. Definitions

Key Risk Indicators can be defined as metrics providing information on the level of exposure to a given operational risk and help to identify, measure, monitor and report on how well a business entity is doing in managing its operational risks.

KRIs must:

- Be specific, measurable and timely
- Cover operational processes that may generate significant operational risks for the ManCo/Funds
- Address delegated functions as well as those performed in the ManCo
- Include benchmarks or traffic light ratings (e.g. green/amber/red or low/medium/high) and thresholds for any type of operational error should show realistic risk situation of the ManCo/Funds to which the KRI refers
- Be regularly reviewed to ensure they remain relevant
- Be calibrated to the ManCo's risk appetite limits

b. The measurement of KRI associated to distribution risk

While the distribution activity may be performed by the ManCo, part of the activities may be delegated to one or more distributors. The scope of the distribution risk oversight and the selected KRIs may accordingly vary based upon the distribution operating model: KRI can be set at the level of the ManCo or at the level of the Distributor.

The sample of KRI presented in the appendices primarily focuses on KRI set at the distributor level. This table is for information purpose only and shall not replace the risk assessment of the risks related to the distribution activity, to be performed by each ManCo.

Examples of KRIs are included in Appendix X.

2. New Business/Risk Approval Process

RM should be involved in assessing the operational, and other, risks that are introduced into the ManCo business as a result of; new products, out-sourcing or delegation of functions, distributing into new jurisdictions, appointing new distributors and any other change to the business or operating processes that result in a change to the risk profile of the ManCo business.

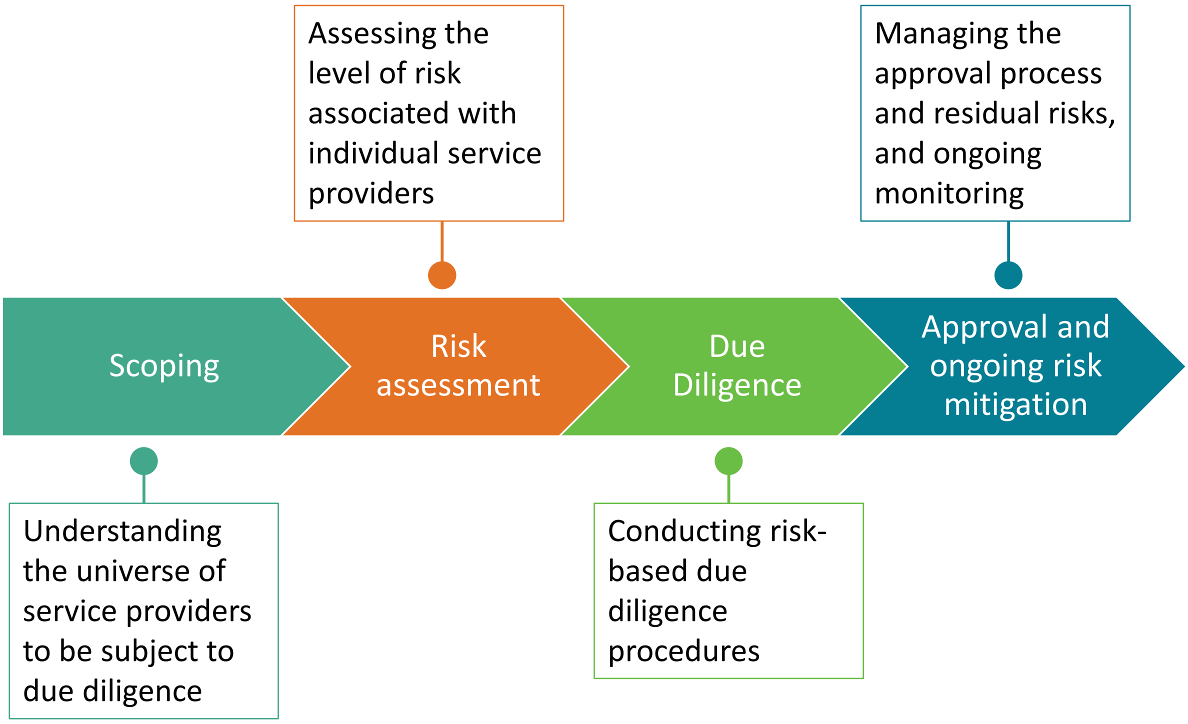
Before agreeing to the acceptance of the change or new business RM, together with senior management and the Board, should ensure that any new risks being introduced are identified, can be satisfactorily controlled and adequately monitored and managed. RM will ensure that the RMP is updated to include how any new risks will be managed and will assist the business in the implementation of additional KRI/KPI as may be needed.

3. Due Diligence

This paper is not intended to describe the processes required to complete the initial due diligence and on-going monitoring that is required of service providers however the ManCo may wish to make reference to the paper Guidelines for the Risk Monitoring of Functions Outsourced/Delegated by a Management Company or Investment Company which has been produced by the ALFI Technical Committee.

As stated above, CSSF Circular 12/546 (clause 7.1.4) requires that every use of an external service provider must be preceded by written due diligence by the management company on the provider. In the context of this requirement of diligence, the management company must, amongst others, identify the operational risks deriving from this delegation.

Example Due Diligence Process Steps



Adequate risk reporting is integral part of a RM function and in particular for the senior management of a ManCo to ensure they can comply with their obligations and responsibilities of oversight. In order to ensure that the RM function obtain the necessary information from other departments as well as from outsourcing partners, a structured bottom up reporting is needed. Based on the information received and the analysis performed by the (risk) department(s) a meaningful reporting to the senior management and/or a Senior Risk Committee is key to making risks transparent as well to propose and finally decide on mitigating measures.

In the case of operational risk events it is often important that prompt escalation and corrective action is taken to avoid the initial error potentially becoming more significant and perhaps impacting additional funds. For example an error that results in a market exposure should ideally be closed on the same business day that it occurs in order to avoid carrying an overnight risk. The Risk policy and procedures should therefore clearly document how risk events are to be treated and the steps to be followed in the case of a risk event. This document should include a clear escalation timeline and hierarchy of escalation.

In addition to timely reporting of operational risk events as they occur, or are identified, all operational risks should be recorded in the Risk Event Database (see above) and included in the regular reporting to senior management and the Board. The 'Best Practice Proposals for the Organisation of the Risk Function of a UCITS Management Company or UCITS Investment Company' paper, mentioned above provides more information on risk reporting but in summary the following reporting requirements should be considered:

- The senior management/Board will receive a holistic report on all relevant risk types aggregated. This report will be based on the data gathered bottom up by risk function/senior management.
- The Head of Risk Management/senior management is responsible to receive necessary bottom up reports from relevant departments and/or service providers.
- The Head of Risk Management/senior management will report at least quarterly to the Board of the ManCo.
- The Head of Risk Management/senior management will ensure that Risk Reports are holistic (considering all risk categories identified), timely and accurate.
- The Risk reports will give info on current/new risks including a statement on severity (e.g. low, medium, high) and its evolution over time and measures to mitigate existing risks where possible.
- The Risk Reports must provide the Board with all necessary information to decide on appropriate measures to be taken to control and mitigate all relevant risks.
- The Head of Risk Management/senior management must ensure that any relevant new risk issues deemed to be high will be reported ad hoc to the Board.
- The Head of Risk Management/senior management will oversee that entities report in a timely, accurate and clear manner and are consistent with the framework set by the risk function.

To help ensure that a full picture of the risks are identified, monitored and reported to management of the appropriate level a Dashboard could be established, taking into consideration the key risks as identified in section IV and the Key Risk Indicators mentioned in section V above. Red-Amber-green (RAG) reporting based on pre-set limits and triggers can also be used, in particular when escalating to the Board.

Depending on the nature of the fund managers target investors it may be appropriate to report on country level and or on channel/business segment level.

The risks for each method are different and the management reporting should be adapted accordingly. For example:

- When distributing to Insurance companies in Germany, the risk maybe to fail to:
    - Comply with VAG and Solvency rules, which manifest at the level of the portfolio manager; and
    - To fail to accurately report.
- When distributing via an international private bank in multiple territories, the risk maybe to fail to:
    - Verify the residence of the end investor

to consider the AML risk, tax risk and tax reporting risk (FATCA, Common Reporting Standard, ...);
- Ensure that the marketing documents used are up-to-date and appropriate;
- Ensure that the advice being given to end investors is appropriate.

- When distributing via investment advisers making use of platform technologies.
  - Verify that the dealing arrangements with these intermediaries do not prevent the ManCos using prospectus powers to suspend dealing, revalue, delay redemptions if necessary in times of market volatility or instability;
  - Determine the contractual relationship between the distributor and the technology platform are in place as relevant to the ManCo.

It is also important the Senior Management challenge the risk reporting

The results of the monitoring should be included in the Company's annual report concerning internal controls to the CSSF.

Business Process	Distribution Process	Examples of Risk	Examples of KRI mitigating control or reporting requirements
Distributor On Boarding	Distribution Selection & Setup	Inadequate and/or incomplete due-diligence	• Number of distributors on-boarded in last month • Number of due diligences planned, % completed, % outstanding, and % action points to be followed up
		Delegation to distributors not covered by a signed legal agreement or covered by a non-standard agreement	Number of unsigned contracts, number of non-standard agreements, date of last legal review
		Failure to comply with regulatory requirements when defining Distributors remuneration	
		Improper oversight of the outsourcing of parts of the distributor's activities to third parties	Number of third-parties sub-contracted
Product & Marketing Setup		Inadequate or incomplete assessment of distribution capability for new products	Should be covered by new product approval processes
		Failure to register/notify funds/ share classes in a jurisdiction before starting to market the Funds	Escalation of any incidents that may occur
		Failure to comply with host country marketing regulations/ material requirements	Review and approval processes for marketing material. Escalation of any incidents that may occur
		Inadequate training to distributors	Training requirements to be assessed for new products. Confirmation that training has been completed
		Reliance on Reverse Solicitation for sale of products	Number of countries where RS is being used. Monitoring that sales are adequately documented
Operations		Non-compliance with host country point of sales regulatory expectations and/or market practices	Escalation of any incidents that may occur
		Non-compliance with appropriate inducement regulations in different jurisdictions	Review of legal agreements for correct terms. Escalation of any incidents that may occur
		Errors in the calculation of the remuneration	Operational controls around the calculation process. Escalation of any incidents that may occur

		Client Complaints not handled in accordance with regulations	• Number of complaints received by the ManCo • Number of complaints received by the distributor(s)
		Suitability/Appropriateness obligations are not completed by distributors	Distributors processes to be assessed as part of initial and ongoing due diligence.
		Failure to monitor for suspicious transactions	Distributors processes to be assessed as part of initial and ongoing due diligence. Appropriate escalation of any incidents.
		Acceptance of trading that may contravene 'Market Timing' regulations	Distributors processes to be assessed as part of initial and ongoing due diligence.
Reporting		Incomplete or misleading information presented to the investors in standard reports	Distributors processes for preparation of marketing, reporting and fund material to be assessed as part of initial and ongoing due diligence.
		Incomplete or misleading tax reporting related to investors (e.g. OECD tax common reporting standards)	Distributors ability and procedures to comply with tax reporting standards to be assessed as part of initial and ongoing due diligence
		Investors are not provided with the latest Fund documentation or notices	Distributors processes for preparation of marketing, reporting and fund material to be assessed as part of initial and ongoing due diligence.
		Late delivery of NAV prices to distribution platforms	Distributors processes for preparation of marketing, reporting and fund material to be assessed as part of initial and ongoing due diligence.
		Incomplete or misleading information published on website to investors	Website statistics: number of visitors by Fund, number of data feed errors, frequency of data update
		Late and/or inaccurate trade confirmation sent to investors	Distributors processes for preparation of marketing, reporting and fund material to be assessed as part of initial and ongoing due diligence
		Incomplete, or inconsistent with fund documents, marketing material	Distributors processes for preparation of marketing, reporting and fund material to be assessed as part of initial and ongoing due diligence
Oversight		Late and /or incomplete oversight reporting including submission of Due diligence questionnaires	Schedule for the completion of ongoing due diligence. Reporting of any 'past due' reviews

Glossary

AIF	Undertakings for collective investment in transferable securities, which is not subject to Part I of the 2010 Law
AML	Anti-Money Laundering as defined in CSSF Regulation N° 12-02 of 14 December 2012 on the fight against money laundering and terrorist financing
Board of Directors	'Supervisory Function' as defined below
Circular 12/546	CSSF Circular issued by the CSSF on 24 October 2012 relating to authorisation and organisation of the Luxembourg management companies subject to Chapter 15 of the Law of 17 December 2010 on undertakings for collective investment as well as to investment companies which have not designated a management company within the meaning of Article 27 of the Law of 17 December 2010 on undertakings for collective investment
Client	Any natural or legal person, or any other undertaking including a UCITS or AIF, to whom a ManCo provides a service of collective portfolio management or services pursuant to Article 101, paragraph (2) of the 2010 Law
Compliance Officer	The person who's effectively responsible on a day to day basis for carrying out the services and activities within the meaning of Article 11 of the Regulation No. 10-4
Conducting Officer	Member of "senior management" as defined below
Counterparty Risk	The risk of loss for the UCITS or AIF resulting from the fact that the counterparty to a transaction may default on its obligations prior to the final settlement of the transaction's cash flow
CSSF	*Commission de Surveillance du Secteur Financier*, the Luxembourg supervisory authority of the financial sector
ESMA	European Securities and Market Authority
EU	European Union
External Service Provider	Any entity to whom the ManCo and Self-Managed SICAV has delegated one or more functions, even if this entity belongs to the same group as the group of the ManCo or of the initiator's Self-Managed SICAV
Fund	(i) any UCITS or AIF managed by a ManCo, AIFM or (ii) a Self-Managed SICAV

Initiator	The entity that has taken the initiative to launch a Fund in Luxembourg
KYC	Know Your Client as defined in CSSF Regulation N° 12-02 of 14 December 2012 on the fight against money laundering and terrorist financing
2010 Law	Law of 17 December 2010 concerning undertakings for collective investment and implementing Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)
2013 Law	Law of 12 July 2103 concerning Alternative Investment Fund Managers and implementing Directive 2011/615/EU of the European Parliament
Liquidity Risk	The risk that a position in the UCITS' or AIF' portfolio cannot be sold, liquidated or closed at limited cost in an adequately short time frame and that the ability of the UCITS to comply at any time with Article 11, paragraph (2) and Article 28, paragraph (1), point b) of the Law of 17 December 2010 concerning undertakings for collective investment is thereby compromised
ManCo	'Management Company' means a management company authorised and subject to chapter 15 of the 2010 Law; an Alternative Investment Fund Manager authorised and subject to the 2013 Law or self managed company
Market Risk	The risk of loss for the UCITS or AIF resulting from fluctuation in the market value of positions in the UCITS' or AIF' portfolio attributable to changes in market variables, such as interest rates, foreign exchange rates, equity and commodity prices or an issuer's creditworthiness
MiFID II	EU Directive 2014/65/EU dated 20 October 2011
Operational Risk	The risk of loss for the UCITS or AIF resulting from inadequate internal processes and failures in relation to people and systems of the management company or from external events, and includes legal and documentation risk and risk resulting from the trading, settlement and valuation procedures operated on behalf of the UCITS or AIF
PRIIPS	EU regulation 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for Packaged Retail and Insurance-based Investment Products

Proportionality	The principle pursuant to which the senior management needs to assess on a case by case basis the relevant human and technical resources - appropriate to the size and the organisation of the ManCo, and to the nature, scale and complexity of its activities
Regulation No. 10-4	CSSF Regulation No. 10-4 transposing Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and the content of the agreement between a depositary and a management company, as amended
Reputational risk	The risk of damaging an entity's trustworthiness in the marketplace, i.e. the impact of specific events that could worsen or negatively affect the perception of an entity
Risk Appetite	The amount of risk exposure (e.g. expressed as monetary), or potential adverse impact from an event, that a ManCo is willing to accept/retain
Risk Management Officer	The person who's effectively responsible on a day to day basis for carrying out the services and activities within the meaning of Article 13 of the Regulation No. 10-4
RM	Risk Management
Self-Managed SICAV	SICAV established under Part I of the 2010 Law which has not designated a ManCo, within the meaning of Article 27 of the 2010 Law
Senior Management	The persons who effectively conduct the business of a ManCo in accordance with Article 102, paragraph (1), point c) of the 2010 Law in other terms 'Conducting Officer'
SICAV	*Société d'investissement à capital variable* (investment company with variable capital)
Supervisory Function	The relevant persons or body or bodies responsible for the supervision of its senior management and for the assessment and periodical review of the adequacy and effectiveness of the risk management process and of the policies, arrangements and procedures put in place to comply with the legal and regulatory obligations, including but not limited with the 2010 Law
UCITS	Undertakings for collective investment in transferable securities, subject to Part I of the 2010 Law

UCITS Directive	Council Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)
Unitholder	Any natural or legal person holding one or more units/shares in a Fund

The Association of the Luxembourg Fund Industry (ALFI), the representative body for the Luxembourg investment fund community, was founded in 1988. Today it represents more than 1 300 Luxembourg-domiciled investment funds, asset management companies and a wide variety of service providers including depositary banks, fund administrators, transfer agents, distributors, law firms, consultants, tax advisers, auditors and accountants, specialist IT providers and communications agencies.

Luxembourg is the largest fund domicile in Europe and its investment fund industry is a worldwide leader in cross-border fund distribution. Luxembourg-domiciled investment structures are distributed in more than 70 countries around the globe, with a particular focus on Europe, Asia, Latin America and the Middle East.

ALFI defines its mission as to "Lead industry efforts to make Luxembourg the most attractive international centre".

Its main objectives are to:

Help members capitalise on industry trends
ALFI's many technical committees and working groups constantly review and analyse developments worldwide, as well as legal and regulatory changes in Luxembourg, the EU and beyond, to identify threats and opportunities for the Luxembourg fund industry.

Shape regulation
An up-to-date, innovative legal and fiscal environment is critical to defend and improve Luxembourg's competitive position as a centre for the domiciliation, administration and distribution of investment funds. Strong relationships with regulatory authorities, the government and the legislative body enable ALFI to make an effective contribution to decision-making through relevant input for changes to the regulatory framework, implementation of European directives and regulation of new products or services.

Foster dedication to professional standards, integrity and quality
Investor trust is essential for success in collective investment services and ALFI thus does all it can to promote high professional standards, quality products and services, and integrity. Action in this area includes organising training at all levels, defining codes of conduct, transparency and good corporate governance, and supporting initiatives to combat money laundering.

Promote the Luxembourg investment fund industry
ALFI actively promotes the Luxembourg investment fund industry, its products and its services. It represents the sector in financial and in economic missions organised by the Luxembourg government around the world and takes an active part in meetings of the global fund industry.

ALFI is an active member of the European Fund and Asset Management Association, of the European Federation for Retirement and of the International Investment Funds Association.

To keep up to date with all the news from the association and the fund industry in Luxembourg, join us on LinkedIn (The Luxembourg Fund Industry Group by ALFI), Twitter (@ALFIfunds), Youtube, Vimeo or visit our website at www.alfi.lu.

September 2015

Best Practice Proposals for the Management of Operational Risks Associated with the Distribution of Funds

alfi

guidelines