DechertOnPoint

July 2012 / Issue 8

A legal update from Dechert's Financial Services Group

Euro Crisis: A UCITS Perspective

The economic uncertainties facing the Eurozone make it increasingly important for investment managers and investment fund ("Fund") boards of directors ("Boards") to anticipate and prepare for the impact of a "Euro event", such as the exit of a country from the Eurozone. A number of recent *DechertOnPoints* (available at: www.dechert.com/euro_crisis) have addressed the steps that investment managers and Fund Boards should be taking to address the risk of the occurrence of a Euro event. As part of the Dechert Euro Crisis series, this *DechertOnPoint* seeks to address some of the specific factors that should be taken into consideration by UCITS Funds ("UCITS") and their Boards when preparing for the possibility of a Euro event.[1]

Experience to Draw From

Many of the issues surrounding a Euro event will be familiar to UCITS, as similar issues were addressed at the time of the financial crisis following the collapse of Lehman Brothers in 2007/2008 (the "Financial Crisis").

In addition to market disruption issues, the UCITS industry has dealt with the issues relating to currency conversion/redenomination when the Euro was introduced in 1999. The Euro implementation process for UCITS went smoothly at that time and, because of this previous conversion/redenomination process, fund administrators and custodians already have the necessary systems, processes and expertise in their playbook to address any similar events. However, while past experience is available to guide service providers there have yet to be any formal policy pronouncements to or enquiries made of service providers by competent authorities in the main UCITS domiciles with respect to Euro contingency planning.

Given this background, it is clear that the UCITS industry is no stranger to dealing with exceptional circumstances; however, as a retail investment product, a strict regulatory regime applies to UCITS and all actions taken must work within the framework. Although designed to protect investors, the nature of UCITS regulation means that there is significantly less scope for management discretion in relation to dealing with the liquidity and valuation issues that might arise from a Euro event. For example, UCITS are prohibited from creating side pockets, whereas other European non-retail regulated funds, such as the Irish Qualifying Investors Fund ("QIFs") or Luxembourg Specialised Investor Fund ("SIFs"), are permitted to do so.

As the Euro crisis still shows no signs of abating, managers and Boards should "be prepared." Below, we set out a non-exhaustive series of issues for consideration by UCITS in developing their own Euro event readiness plan.

Analysis of Fund Documentation

Prospectus

Critical to the Euro event readiness of a UCITS is an analysis of the UCITS prospectus. As detailed below, a starting point for any considerations is to assess the level of investor involvement required for any necessary changes. Examples include requirements for

---

[1] This update further builds on the 21 June 2012 *DechertOnPoint* "Eurozone Break-Up: Contingency Planning for UCITS."

obtaining shareholder approval or shareholder notification and, for Funds with a smaller number of investors, discussing the available options with them so that necessary decisions are taken by the investors themselves.

Investment Objectives and Policies

The investment objectives and policies of UCITS should be reviewed and stress-tested for a Euro event. For example, is there an ability to hedge currencies or to hold defensive cash positions?

It may also be useful to provide for a general power permitting the Board/investment manager to take all action that it considers in the best interests of unit holders to protect the assets of the Fund if a Euro event occurs. In such circumstances, it is likely that regulators will not provide a carte blanche to Boards/investment managers, and that regulators will ask what actions would be contemplated in such a scenario so that these can be set out in the UCITS prospectus.

UCITS should undertake a full analysis of their Euro exposure which may arise directly through investment in European securities or money market instruments, but which may also arise indirectly through investment in securities that have significant European exposure or where counterparties have significant Euro exposure. For example, while a U.S. equity Fund may invest exclusively in companies that are listed or traded on regulated markets in the United States, the underlying businesses of such companies may derive a substantial part of their revenue from Europe, and the extent of exposure to the Eurozone, and Europe generally, should be considered as part of the analysis.

It is possible that the occurrence of a Euro event could result in the breaching of investment objectives and policies of a UCITS. An example of this would be a policy to purchase investment grade fixed income securities that is breached as a result of the downgrading of Eurozone fixed income securities to "junk" status.

For Irish UCITS that invest in bonds, the prospectus must disclose the bonds' investment rating, and there is a requirement that any UCITS which invests more than 30% in below investment grade securities must provide enhanced risk disclosure to the effect that an investment in the UCITS "should not constitute a substantial proportion of an investment portfolio and may not be appropriate for all investors".[2] Given these requirements, bond portfolios and reports of ratings agencies should be monitored closely to avoid a breach.

While there is a requirement that active breaches be rectified immediately, breaches that result from market movements or other issues that occur after the investment is made are considered to be passive. Where a breach is passive, such as a breach due to changes in the credit ratings of underlying investments, it is required that the breach be rectified at the earliest possible opportunity taking due account of the best interests of unit holders.

While this does give the Directors of the UCITS a degree of discretion, it is better that breaches of any nature are avoided by anticipating the likely investment consequences of a Euro event in drafting or amending the investment objectives and policies. UCITS rules provide that any changes to the investment objectives, or a material change to the investment policies, of a UCITS cannot be made without the unanimous written consent of the unit holders or a majority vote at a general meeting. "Material" changes are those that "would significantly alter the asset type, credit quality, borrowing limits or risk profile of the UCITS."[3]

If such changes are effected via shareholder vote at a general meeting, reasonable notice must be provided to unit holders before the changes take effect, so that they might redeem their units if they do not want to continue their investment. Further, non-material changes require that notice is provided to unit holders as well.

Given the time and resources that are necessary to effect changes to the investment objectives and policies, UCITS that are structured as companies may wish to utilise the annual general meeting required to be held each year as an appropriate opportunity to effect any such changes. Addressing such issues as part of sensible Euro event planning via the established annual process is less likely to lead to adverse shareholder consequences, such as redemptions, than when the requirements to change are forced on the UCITS.

---

2 Central Bank of Ireland UCITS Application form 2 – Prospectus 2.2.7-2.2.8.

3 Central Bank of Ireland UCITS Notice 5.4 (22).

Risk Factors

Many prospectuses may not contain Euro event risk disclosure because they were written before, and may not have been updated to take account of, the Euro crisis. Accordingly, any UCITS that has material direct or indirect exposure to Eurozone risks should ensure that these risks are adequately addressed in the prospectus.

UCITS prospectuses are required to "contain sufficient information for investors to make an informed judgment of the investment proposed to them and in particular of the risks attached to that investment." As such, it is best practice that the prospectus is updated, and the updated version should be sent to all investors.

Liquidity and Valuation Risks – Overview: There are a number of possible ways that liquidity could be impacted by developments in the Eurozone. One example is where a country leaves the Euro. While there is no formal mechanism currently in place to enable a country to leave the Euro and re-establish a local currency, there has been increased speculation that one or more Eurozone countries will revert to their legacy currencies either voluntarily or by action of the EU.

In the aftermath of a currency redenomination, there are numerous events that could impact liquidity, including, without limitation, market closures, bank holidays and restrictions on currency convertibility. If any of these occur, a UCITS would be forced to quickly assess both the valuation and liquidity of its impacted holdings.

In light of these risks, UCITS managers should review the current valuation and liquidity policies and procedures (as set out in more detail below) to determine whether they are adequate to address these types of events. In particular, UCITS managers may want to consider whether any changes are needed to the Fund's fair valuation procedures. For example, if a UCITS holds substantial amounts of sovereign debt, or derivatives on such debt, management may want to consider the need for specific procedures for fair valuation of such securities and instruments and whether additional sources for valuation should be readied for use in a distressed market.

Liquidity Risk: In the context of its overall assessment of exposure to the Eurozone, UCITS should consider the liquidity of their current positions that have exposure to the Eurozone, either directly or indirectly. In the event of a sovereign default, redenomination or other similarly significant event, an exposed UCITS could face substantial redemption activity as panicked investors scramble to re-allocate assets. This could result in a liquidity crunch for the UCITS, particularly if it has to liquidate affected positions during a bank holiday or market closure. Even where markets remain open, a crisis can have the effect of substantially depressing market liquidity and causing precipitous declines in market prices.

One option in the face of liquidity pressures is for a UCITS with exposure to Eurozone risk to adopt a "temporary defensive position" and increase its holdings in cash and other liquid securities. While this would provide an additional cushion in the face of large-scale redemptions, there is an obvious downside to a UCITS deviating from its main investment strategy, particularly for any prolonged period of time. UCITS managers should review the prospectus disclosures to ensure they provide the express ability to deviate from the principal investment strategy as a temporary defensive measure. A UCITS that continues to remain in a temporary defensive position could underperform its peer funds and, in any event, may tend to deviate substantially from any applicable benchmarks. Institutional investors, in particular, would not be likely to tolerate a large temporary defensive position for long periods.

UCITS managers should consider whether they have other necessary tools in their toolbox to mitigate a liquidity crisis, including detailed disclosure on suspensions, redemptions in kind, gating and valuation. While suspension, gating and redemptions in kind present both regulatory and operational issues as well as client relations concerns, a UCITS manager should at least have disclosures that could contemplate such actions in the event of a partial or complete disintegration of the Eurozone.

Operational Risks: The potential Eurozone crisis presents a number of operational risks for UCITS. For example, cash payments into and out of a country that withdraws from the Euro are an obvious source of risk, because they are liable to instantaneous redenomination. A currency redenomination could also impact systems that are used by a UCITS for various trading, financial reporting and compliance functions. In addition, there could be delays in the settlement and clearing of trades. Such delays, as well as questions about valuation, could pose significant concerns for affected UCITS.

While the risks discussed above primarily focus on the UCITS manager, planning for operational risks requires a broad focus that should also include the Fund's custodian and administrator. UCITS managers should begin to reach out to their global custodian to determine whether it has a contingency plan in place for the break-up of the Eurozone. In addition, UCITS may wish to revisit the liability provisions in their custody agreement, particularly with respect to sub-custody risk.

Other Risks: A Eurozone country's return to its legacy currency would create other complications for UCITS that have contractual arrangements with an entity located in that country, particularly where the counterparty's obligations are denominated in Euro. In many cases, an exit from the Euro and redenomination is not explicitly addressed in the existing contracts for these trades, particularly trades that were entered into some time ago. Accordingly, the interpretation of these agreements would present a UCITS with a degree of legal uncertainty which, depending on the size and nature of these agreements, could have a material impact on the value of shares as well as the liquidity of the UCITS. Any potentially impacted agreement should be reviewed with this scenario in mind. Choice of law and dispute resolution provisions should particularly be considered and, if necessary, experts on the local jurisdictions should be consulted.

Finally, another risk faced by UCITS is that a default or other negative event in Europe in connection with the sovereign debt crisis (e.g., bank failures or downgrades) could potentially cause many investors to choose to move from investments that they perceive to be risky, even if the fundamentals of these investments are strong. For example, emerging market debt and equity UCITS may face redemptions due to investors choosing to move to asset classes viewed as less risky, such as U.S. government securities. This type of risk may be harder to anticipate, particularly where a UCITS does not have direct exposure to the Eurozone. Nevertheless, advisers to UCITS that invest in asset classes that are generally viewed as more risky should consider the degree to which increased difficulties in the Eurozone could impact these UCITS.

Euro Definition

Most prospectuses define the Euro as the "currency introduced at the start of the third stage of the economic monetary union pursuant to the Treaty of Rome dated 25 March, 1957 establishing the European Union." In the event of a Euro-break up and the currency no longer existing, provision will need to be made for a successor currency, and it would appear appropriate to provide for a successor currency "as determined at the discretion of the Directors" in the prospectus.

Prior to the introduction of the Euro, most UCITS had the US Dollar as their base currency, with currency classes most commonly denominated in Sterling and Deutsche Mark. Due to the provenance of their investment managers, the US Dollar remains the predominant base currency for Irish UCITS; however, share classes that were denominated in Euro legacy currencies such as Deutsche Mark or French Franc are now denominated in Euro. As such, an alternative would be to provide for the currency that is the lawful currency of e.g., Germany, either upon a Eurozone break-up or upon the exit of a Eurozone member.

Base Currency

For UCITS that have the Euro as their base currency, the obvious concern is that countries may leave the Euro or that the currency will cease to exist. The base currency is important from two perspectives. Firstly, it is the currency in which the financial statements of the UCITS are prepared and reported. Secondly, it is generally the currency in which the majority of a UCITS' underlying investments are denominated. Investments may also be made in other currency denominations and it is a matter for the investment policy of the UCITS as to whether or not such foreign currency investments are hedged.

The base currency of a UCITS and the currency denominations of share classes are generally driven by the underlying investments of the UCITS or the currency of the principal investors, not by the local currency of the UCITS domicile. The base currency is likely to be the local currency of the jurisdiction where the Fund is most actively marketed, with the US Dollar used as the reserve currency for UCITS that are very broadly marketed. In which case, hedging becomes more important as it is the currency in which investors have invested.

Concerns about a UCITS reporting in a currency that no longer exists can be dealt with by the change in definition referred to in the preceding section. However, if the majority of the UCITS' underlying assets are denominated in Euro, then it is this Eurozone exposure rather than the base currency that should be the greater cause for concern. If this exposure is reduced, either within the parameters of the existing investment policies of the UCITS or upon a change of such policies, then it may provide a justification for a change in base currency and a redenomination of shares.

Currency Hedging

Most UCITS that do not have the Euro as their base currency will have Euro currency classes to facilitate investment by European investors. In most cases, the Euro share class will be hedged against the base currency.

If concerns about the Euro grow and currency hedging becomes more difficult, some UCITS managers, e.g., a U.S. small cap equity manager, may wish to consider whether they want to continue to provide currency hedging (which is not a core offering) as part of their UCITS offering. This would be particularly true for smaller managers. UCITS may also consider whether they should withdraw the offered Euro currency shares and redenominate the Euro share classes to US Dollar share classes or switch investors into existing US Dollar share classes. Such actions would likely require shareholder approval but this could be achieved at class, as opposed to Fund, level.

Articles of Association

During the Financial Crisis, regulators across Europe adopted a pragmatic approach to issues such as the use of fair value adjustments and suspensions, provided that action taken was in accordance with the constitutional documents of the UCITS. Unfortunately, in some instances, actions proposed by investment managers and supported by Boards could not be taken, as such actions would have been ultra vires from the perspective of being not permitted by the constitutional documents of the Fund.

Typically, for UCITS structured as companies, there will be a time lag of up to one month in effecting changes to constitutional documents from the time the necessary changes have been agreed by the Board, the necessary circular to unit holders has been drafted and statutory notice has been provided. As such, the key is to ensure that constitutional documents provide the maximum flexibility that can be afforded to the Board within the scope of the UCITS Directive.

Valuation Provisions

The general rule for UCITS is that valuation shall be based "in the case of securities traded on a stock exchange or regulated market, on the last known stock exchange or market quotation unless such quotation is not representative"[4] unless otherwise provided for in the constitutional documents of the UCITS.

In Ireland, the Central Bank has given guidance as to what it expects to see in the valuation provisions for UCITS — it will permit the use of fair value pricing where "such adjustment is considered necessary to reflect the fair value in the context of the currency, marketability, dealing costs and/or such other considerations which are deemed relevant."[5] The Central Bank requires that where such an adjustment takes place, the rationale for making the adjustment must be clearly documented and, when departing from stated valuation policies, Boards must ensure that the rationale for an adjustment will stand up in the context of the criteria set out above.

Properly implemented fair value procedures will probably address most of the valuation issues that are likely to arise. However, consideration should also be given as to what form these procedures should take, for example:

- the establishment of a Board valuation committee;
- obtaining alternative pricing quotes;
- agreement of what reports and recommendations will be taken into consideration when arriving at a fair value adjustment; and

---

4 Central Bank of Ireland UCITS Notice 5.4 (13).

5 Central Bank of Ireland Guidance Note 1/00 – Valuation of the Assets of Collective Investment Schemes Section 1 Note ii – Adjustments.

- agreeing the input from the investment manager, administrator, auditor and legal counsel.

In particular, it will be necessary to ensure that the fund administrator is able to implement valuation procedures and policies that might be outside the scope of its own internal procedures.

Market Disruption Events

The 9/11 attacks, Black Monday, the Financial Crisis and the risk of Euro events are indicators that market disruption events must be anticipated and provided for by UCITS. It is increasingly common to make specific provision for market disruption events in UCITS prospectuses that permit Boards to employ powers such as suspensions, gating and net asset value ("NAV") adjustments.

Suspensions

A fundamental feature of UCITS is their liquidity, evidenced by the primacy of the ability to redeem on notice. However, a UCITS is permitted to, and shall if required by the relevant competent authority, "in the cases and according to the procedure provided in its trust deed, deed of constitution or articles, temporarily suspend the repurchase or redemption of its units".[6] Accordingly, the constitutional documents of the Fund should be reviewed to ensure that the suspension provisions adequately cover possible Euro events.

Suspension may be provided for only in exceptional cases where circumstances so require and suspension is justified having regard to the interest of the unit holders. A Euro event would almost certainly constitute an exceptional case justifying a suspension. While the UCITS Directive makes reference to suspension of repurchase or redemption requests, because a UCITS must be valued as often as it deals, such a suspension invariably also implies a suspension of the calculation of the NAV of the UCITS. It will be the inability to properly value the UCITS that will, in most cases, give rise to the temporary suspension.

While the relevant competent authority must be notified of a suspension immediately, there is no formal requirement to notify investors. However, a notification to investors is considered to be good practice and attention should be given to the mode and content of such a communication.

The suspension should be temporary, to the extent that is should not be considered permanent, and it should be brought to an end as soon as possible. The Boards of UCITS should critically assess any recommendation to temporarily suspend redemption and they should, on a frequent basis, reassess the suspension and liaise constantly with the relevant competent authorities.

Gating

While in the exceptional circumstances of a Euro event, suspension is the measure that most likely could and should be deployed, most UCITS articles will also provide for gating procedures. For UCITS, this is typically a provision that permits gating where redemption requests exceed 10% of the units in issue of the UCITS/sub-fund or 10% of the NAV of the UCITS/sub-fund on any dealing day.

Although gating can be employed at any time without the justification of an exceptional event, market practice for UCITS has been to use this ability sparingly. Regardless, prudent planning for a Euro event would entail a review the UCITS' constitutional documents to ensure that this flexibility is available.

Redemption in Kind

In circumstances where it is not possible to either accurately value a UCITS or provide liquidity, the option of making a redemption in kind should be considered. In general for UCITS, redemption in kind requires the consent of the redeeming investor. However, a redemption in kind may be made at the discretion of the UCITS if the redemption requested equates to more than 5% of the NAV of the UCITS. While such redeeming investors may request that such assets be sold on the investor's behalf, it is unlikely that such sales would be made into a distressed market.

Again, fund documentation should be reviewed to ensure that this power is available. In addition, the profile of investors will need to be reviewed to ensure that they are in a position to receive a redemption in kind from a custody perspective.

[6] Directive 2009/65/EC (recast) 13 July 2009 Article 84(2)(a).

While it is recommended that the options of gating or a redemption in kind be considered, these represent piecemeal or investor-by-investor options. A suspension has the advantage of putting all investors in the same position at the same time thereby reducing the risk of challenge in terms of equal treatment of investors.

Winding Up

All UCITS are required to outline the circumstances in which they can be wound up or in which a sub-fund may be terminated. Again, the constitutional documents should be reviewed to consider what options might be available to a UCITS should the economic circumstances render the continuance of the UCITS unviable.

Counterparty Agreements

The *DechertOnPoint* "The Euro Crisis – Contingency Planning for Asset Managers – 17 April 2012" sets out in detail the matters that UCITS, and their investment managers and Boards, should consider upon a Euro event. Of particular note in this regard is the discussion relating to counterparty agreements, borrowing and use of financial derivative instruments ("FDIs").

As significant users of FDIs, the counterparty agreements entered into by UCITS should be reviewed and any items of concern in such documents raised. In particular, credit exposure to counterparties and the quality of collateral must be reviewed at all times for the purposes of ensuring that the regulatory criteria are met, including:

- **Liquidity:** Collateral must be sufficiently liquid in order that it can be sold quickly at a robust price that is close to its pre-sale valuation.
- **Valuation:** Collateral must be capable of being valued on at least a daily basis and must be marked to market daily.
- **Issuer credit quality:** Where the collateral issuer is not rated A-1 or equivalent, conservative haircuts must be applied.
- **Safe-keeping:** Collateral must be transferred to the trustee, or its agent.
- **Enforceability:** Collateral must be immediately available to the UCITS, without recourse to the counterparty, in the event of a default by that entity.
- **Non-cash collateral**:
  - ❑ cannot be sold, pledged or re-invested;
  - ❑ must be held at the risk of the counterparty;
  - ❑ must be issued by an entity independent of the counterparty; and
  - ❑ must be diversified to avoid concentration risk in one issue, sector or country.
- **Cash collateral:** must only be invested in risk-free assets.

Communication

Board Communication

UCITS and their Boards will be heavily reliant on the input and guidance of the UCITS investment manager in dealing with any Euro events that arise. UCITS management should ensure that there is open communication with the UCITS Board (or management company) and that an agreed-upon oversight process has been established. This process should include a means for communications between meetings in the event that the crisis worsens in advance of a planned meeting date. Additionally, if they have not already done so, UCITS management and the Board should reach an understanding on how emergency communications should be conducted.

In these situations, it is also necessary to discuss and agree the degree of delegation that will be permitted within the Board itself, as well as the extent to which the Board is comfortable delegating to the UCITS management the ability to take certain actions prior to receiving Board approval in the event of a crisis. While some UCITS may be able to leverage off prior experience with these types of crisis communication protocols, other UCITS may need to develop these types of processes for the first time.

As indicated below, the form of reporting from the investment manager and other service providers should be agreed as part of the UCITS' business plan/risk management process document ("RMP"). Additionally, it may be worth considering putting in place a Euro crisis committee comprised of representatives of the UCITS Board and the investment manager, with responsibility for Euro contingency planning.

Investor Communication

UCITS advisers may wish to consider communicating to investors information on the potential Eurozone crisis and the steps that the UCITS has taken, or will be taking, to protect itself. Such communication could be in the form of a letter to investors, white paper, notice on UCITS' website, stock exchange announcement or other communication. As with any type of fund or adviser communication, it is critical for such a piece to be fair and balanced and subject to the appropriate procedures for the review of marketing materials.

Risk Management

A cornerstone of the UCITS product is its focus on risk management. UCITS are required to "put in place procedures designed to ensure that all applicable risks pertaining to the management company and the Collective Investment Scheme under management can be identified, monitored and managed at all times."[7] In order to ensure that this requirement is addressed, under UCITS IV, each UCITS must appoint a permanent risk manager and have a designated director (or third-party secondee called a "designated person") that is in charge of monitoring risk.

The permanent risk manager is required to, inter alia: implement the risk management policies and procedures of the UCITS; ensure compliance with the risk limits (i.e., counterparty exposure and global exposure limits); advise the Board in relation to identification of risk and the risk profile of the UCITS; and provide regular reports to the Board. This includes, where applicable, monitoring the investment in and valuation of FDIs as set out in the UCITS' RMP. Each area of service to the UCITS is addressed in the business plan, which sets out the processes and reporting requirements in relation to each aspect of the day-to-day functions of the UCITS.

In Ireland, the operation of the risk function in UCITS (which generally operate on a model whereby all day-to-day activity is outsourced by the Board) is reliant upon the risk policies in place in the underlying service providers, which must be compliant with relevant Irish laws and guidance in relation to UCITS. The permanent risk manager will generally receive detailed reports of all areas of risk (e.g., custody of assets, valuation, trade settlement, FDI use, liquidity of the UCITS, and counterparty exposure) from the relevant underlying service provider, the contents of which are specified in the business plan and the RMP. These reports are usually received on a monthly basis by the permanent risk manager, or an ad hoc basis if an issue arises. The designated person will also receive these reports as well as a report from the permanent risk manager. On a quarterly basis, the Board will be provided with a report/confirmation in relation to the operation of the risk management of the UCITS from the designated person and/or the risk manager depending on how it is agreed in the business plan.

Accordingly, UCITS will need to consider whether their business plans, RMPs and related third-party reporting need to be updated to specifically provide for Euro-related risk monitoring as well as a requirement that the reports of the risk manager include an assessment of the risk of the UCITS and/or its share classes in relation to the Euro and the UCITS' abilities to withstand a Euro event. The requirements for the investment management report may also include a statement as to the exposure of the UCITS to Euro-denominated securities and Eurozone issuers as well as counterparties that have significant Euro-related considerations. All business plans and RMPs must also include mechanisms by which a market disruption event will be reported to the Board so that immediate action can be taken. Should an imminent Euro event materialise, the Board should be notified and the risk manager and investment manager could then work with the Board to address the considerations that must be undertaken in accordance with the best interests of the unit holders and the principle of equal treatment of investors.

---

7 Central Bank of Ireland UCITS Notice 2.5 (10(iii)).

Liquidity Management

In order to meet the obligation to "redeem or repurchase units at the request of the unit-holder",[8] UCITS must employ an appropriate liquidity risk management process and, where appropriate, conduct stress tests that enable assessment of the liquidity risk of the UCITS under exceptional circumstances. Given the risks inherent in a Euro event, the Board of a UCITS with Euro exposure should consider whether stress tests should be conducted.

Arrangements With the UCITS Administrator and Custodian

Contingency Planning

As indicated, UCITS administrators and custodians likely will have already dealt with the issues being considered, both at the time of the Financial Crisis and upon the introduction of the Euro. As such, it is expected that they will have contingency procedures in place to deal with Euro events, which should be built into the risk management and liquidity management processes.

In particular, Boards of UCITS should be able to enquire of their administrator and custodian:

- How will trades be settled?
- How will trades and assets be valued?
- How will cash in redenominated currencies be settled?
- Can custody of assets be secured/ segregation be assured in possible exiting countries?
- Are custodians satisfied with their sub-custodians in possible exiting countries?
- How should cash held with sub-custodians in possible exiting countries be treated?

[8] Central Bank of Ireland UCITS Notice 9.5 (1.2.2).

Review of Agreements

Service provider agreements should be reviewed to ensure the ability of the provider to deal with a Euro event. In particular, UCITS should ensure that service providers will "go the extra mile" that may be needed should a Euro event occur, and that they will not seek to rely either on force majeure provisions or argue that extra services required (e.g., urgent introduction of new share classes) are not "in scope" under the terms of the relevant agreement. Extra work such as enhanced reporting, may be required of service providers, either as a contingency or upon a Euro event. This may impact the fee arrangements for UCITS.

The liability of custodians with regard to sub-custodians is to exercise "care and due diligence in choosing and appointing a third party as a safe-keeping agent".[9] In Ireland, the Central Bank identified certain limited circumstances in which custodians may have no liability for losses where assets are entrusted to a sub-custodian. However, the markets contemplated are "underdeveloped or emerging" markets and not mature European markets. This limits the ability of custodians to avoid liability, and custodian agreements should be carefully reviewed with regard to exclusions of liability. Provisions relating to choice of law and payment obligations should also be carefully reviewed.

Subscription and Redemption Arrangements

Where accounts with placement agents, distributors or subscription and redemption accounts are located in a country exiting the Euro, there will be concerns about whether those accounts will be redenominated in the new local currency of the exiting Member State.

In such circumstances, while investors may be repaid in the new currency, the redemption will be linked to the value of the underlying assets of the Fund, as stated in the new currency, so that it will

[9] Central Bank of Ireland Guidance Note "Trust Deeds/Custodian Agreements, Trustee Liability and Standards of Care, Appointment and Supervision of Sub-Custodians" (2. Sub-Custodians, (a) Standard of Care).

effectively be a currency conversion without necessarily resulting in a diminution in the value of the underlying investments.

Money Market Fund Issues

The *DechertOnPoint* "U.S. Money Market Funds and the European Sovereign Debt Crisis," sets out in detail the matters that UCITS structured as money market funds, their investment managers and Boards should consider upon a Euro event.

Money market funds were significantly impacted by the Financial Crisis and all of the tools described in this *DechertOnPoint* were used by UCITS money market funds along with other tools (such as support agreements) to prevent UCITS money market funds from "breaking the buck." Reforms were introduced in both Europe and the United States after the Financial Crisis and the U.S. Securities and Exchange Commission is seeking to go further. It is very likely that any reforms that are introduced in the United States will be followed in Europe as the EU works through its review of shadow banking. These reviews and reforms are a direct result of both the Financial Crisis and the Eurozone crisis, and UCITS Boards will need to keep developments on both sides of the Atlantic under review.

Conclusion

Like a building in an earthquake zone, the survival of a UCITS in a Euro event will be largely dependent on flexibility and good planning. Building on the regulatory framework in place and on experience from the past, UCITS are well placed to handle a major Euro event. However, this does not mean UCITS should sit idly by and wait for an event to happen without stress testing their Fund and developing a plan of action for dealing with the fallout of a Euro event. Conducting a review of the UCITS' documentation, a Board should ensure that the investors are informed in advance of the risk of a Euro event and that the necessary provisions are in place to allow the Board to move swiftly in a crisis. If any gaps are discovered, these should be filled as rapidly as possible. UCITS should also work with their service providers to assess the providers' capabilities of attending to the UCITS' needs (e.g., redenomination, valuations) during a Euro event and to determine how prepared they are to withstand such a crisis themselves. These simple measures will not only help to protect investors in the long run, but will help to reassure them of the safety of their investment in these uncertain times.

■ ■ ■

This update was authored by Declan O'Sullivan (+353 1 436 8510; declan.osullivan@dechert.com), with thanks to Lindsay Trapp for her contributions to this article.

Practice group contacts

For more information, please contact the author, one of the attorneys listed or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financial_services.

Karen L. Anderberg
London
+44 20 7184 7313
karen.anderberg@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Christopher D. Christian
Boston
+1 617 728 7173
christopher.christian@dechert.com

Peter D. Astleford
London
+44 20 7184 7860
peter.astleford@dechert.com

Gus Black
London
+44 20 7184 7380
gus.black@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Dechert LLP

Alain Decombe
Paris
+33 1 57 57 82 82
alain.decombe@dechert.com

Graham Defries
London
+44 20 7184 7661
graham.defries@dechert.com

Eric Deltour
Brussels
+32 2 535 5418
eric.deltour@dechert.com

Karl J. Paulson Egbert
Hong Kong
+1 852 3518 4738
karl.egbert@dechert.com

Carsten Fischer
Frankfurt
+49 6977 06 19 42 11
carsten.fischer@dechert.com

Joseph R. Fleming
Boston
+1 6178 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Richard Frase
London
+44 20 7184 7692
richard.frase@dechert.com

Richard D. Jones
Philadelphia
+1 212 698 3844
richard.jones@dechert.com

Matthew K. Kerfoot
New York
+1 212 641 5694
matthew.kerfoot@dechert.com

Angelo Lercara
Munich
+49 89 21 21 63 22
angelo.lercara@dechert.com

Angelyn Lim
Hong Kong
+852 3518 4718
angelyn.lim@dechert.com

Stuart Martin
London
+44 20 7184 7542
stuart.martin@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Michelle Moran
Dublin
+353 1 436 8511
michelle.moran@dechert.com

Jack W. Murphy
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

Henry N. Nassau
Philadelphia
+1 215 994 2138
henry.nassau@dechert.com

Declan O'Sullivan
Dublin
+353 1 436 8510
declan.osullivan@dechert.com

Federico G. Pappalardo
Munich
+49 89 21 21 63 11
federico.pappalardo@dechert.com

Achim Pütz
Frankfurt
+49 69 7706194212
achim.puetz@dechert.com

Wayne Rapozo
London
+44 20 7184 7671
wayne.rapozo@dechert.com

Kevin P. Scanlan
New York
+1 212 649 8716
kevin.scanlan@dechert.com

Jonathan A. Schur
Paris
+33 1 57 57 80 53
jonathan.schur@dechert.com

Marc Seimetz
Luxembourg
+352 45 62 62 23
marc.seimetz@dechert.com

Jeremy I. Senderowicz
New York
+1 212 641 5669
jeremy.senderowicz@dechert.com

Hans Stamm
Munich
+49 89 21 21 63 42
hans.stamm@dechert.com

Thomas P. Vartanian
Washington, D.C.
+1 202 261 3439
thomas.vartanian@dechert.com

David A. Vaughan
Washington, D.C.
+1 202 261 3355
david.vaughan@dechert.com

Benedikt Weiser
Frankfurt
+49 6977 06 19 42 20
benedikt.weiser@dechert.com

M. Holland West
New York
+1 212 698 3527
holland.west@dechert.com

Sign up to receive our other *DechertOnPoints*.

Dechert LLP

www.dechert.com

Almaty • Austin • Beijing • Boston • Brussels • Charlotte • Chicago • Dubai • Dublin • Frankfurt • Hartford
Hong Kong • London • Los Angeles • Luxembourg • Moscow • Munich • New York • Orange County • Paris
Philadelphia • Princeton • San Francisco • Silicon Valley • Tbilisi • Washington, D.C.