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Eurozone Break-Up: Contingency Planning for UCITS

Over the last decade, the UCITS (Undertakings for Collective Investments in Transferable Securities) product has enjoyed tremendous success globally. Within Europe, the growth of UCITS has been fueled in part by not only product innovation but the introduction of the Euro in 1999. In the face of the potential disintegration of the Euro in the midst of a sovereign debt crisis in one or more European countries, management and boards of UCITS should consider a variety of potential risks and scenarios as part of an effective risk management program. This *DechertOnPoint* will highlight certain key considerations for UCITS in evaluating and planning for a potential complete or partial break-up of the European Monetary Union (Eurozone).

UCITS Risk Management

Overview of the Risk Management Process

The UCITS Directive establishes the obligation for the home Member State of a UCITS to require UCITS to have adequate procedures and internal control mechanisms in place, including with respect to principles for the measurement and management of risks associated with positions in derivatives. Generally, UCITS are required to implement a documented risk management process that is designed to identify and manage material risks to which UCITS are exposed in relation to the performance of the activity of collective portfolio management. Recent market events and the pending uncertainty with the Eurozone have emphasized the need for a comprehensive review of UCITS risk management procedures to identify and manage all materials risks.

Risks Relating to a Potential Eurozone Crisis

There are a number of direct and indirect risks arising from a potential Eurozone crisis. Because of the changing parameters of the Eurozone crisis, the list below is not intended to be exhaustive. Moreover, as events unfold, a fund's risk management efforts need to be ongoing and responsive to changing developments. Following is a discussion of some of the most significant risks at the current time.

Direct and Indirect Exposure on UCITS Portfolio

Eurozone Sovereign Issuers

The most direct investment risk that a UCITS can face is where a fund holds a debt security from sovereign issuers that suffer downgrades or defaults. This direct exposure should be easy to quantify, although there are differing, and changing, views of the risks of certain European sovereign issuers, such as Italy. A fund's holding of a derivative instrument directly exposed to a sovereign issuer (such as a credit default swap) should also be considered when evaluating direct investment exposure. UCITS managers should begin to review their portfolio holdings to quantify and evaluate their direct exposure to sovereign

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debt. In such cases, these investment exposures should generally be reported to, and discussed with, the UCITS board or the board of the management company.

Indirect Exposure to the Eurozone

A UCITS' potential investment exposure is obviously not limited to direct holdings of sovereign debt. A number of large financial institutions, particularly in Europe, are known to have large exposure to the sovereign debt of Greece and other troubled countries. The financial institution's exposure can be both direct (holding sovereign debt) or indirect through derivatives. Other types of issuers may also have substantial exposure to the Eurozone. In contrast to direct exposure to sovereign issuers, these types of indirect exposures are more difficult to quantify. Nevertheless, UCITS managers should be actively considering the ways in which advised UCITS are directly and indirectly exposed to the potential Eurozone crisis.

Liquidity and Valuation Risks

Valuation Risks Relating to Currency Re-Denomination

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 return to its 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 market closures, bank holidays, restrictions on currency convertibility and other events. 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 should review their current valuation and liquidity policies and procedures to determine whether they are adequate to address these types of events. In particular, UCITS fund 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 direct and indirect exposure to the Eurozone, a UCITS should consider the liquidity of its current positions that have exposure to Eurozone risks either directly or indirectly. In the event of a sovereign default, re-denomination, or other similarly significant event, an exposed UCITS could face substantial redemption activity as panicked investors move quickly 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 in an affected country. 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 period of time. UCITS should review their prospectus disclosure to ensure detailed language is included that will provide the express ability to deviate from their principal investment strategy as a temporary defensive measure. A UCITS fund that continues to remain in a temporary defensive position could underperform its peer funds and, in any event, will 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, it would be prudent to at least have disclosure that such actions could be contemplated 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, since 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. Delays in settlement and clearing and questions about valuation will 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 UCITS' custodian, as well as the administrator and accounting agent if those roles are handled by a different entity. UCITS managers should begin to reach out to their global custodian, to determine whether their custodian has a contingency plan in place for the break-up of the Eurozone and how any sub-custodians located in "at risk" Member States would be handled. 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 presents 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 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) would potentially move many investors out of investments that they perceive to be risky, even if the fundamentals of those investments are strong. For example, emerging market debt and equity UCITS may face redemptions following investor movement into asset classes viewed as less risky, such as US 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.

UCITS Contingency Planning for a Potential Eurozone Crisis

UCITS managers should consider each of the areas of potential risk discussed (as well as any other potential areas of risk) in consultation with all relevant service providers. Depending on the UCITS' investment strategy, risk profile and exposure to the Eurozone, some or all of these risk areas may not be relevant to the particular UCITS. As these areas of risk are evaluated, contingency plans should be developed to address any material risk exposures that have been identified. While it is not possible to plan for every contingency, a UCITS should consider the following points in evaluating its contingency planning:

- **Calculation of Eurozone Exposure/Hedging**: UCITS managers should take a full assessment of the direct and indirect exposure of the UCITS portfolio to the Euro. This assessment should be considered in light of a worst case scenario. Fund management should then consider whether the portfolio (or individual share classes) should be hedged to reduce exposure to the Euro. The fair valuation policies of a UCITS should also be reviewed in assessing the impact on valuation of the Euro exposure.

- **Prospectus Disclosure**: With respect to any UCITS that has material direct or indirect exposure to Eurozone risks, the UCITS should evaluate its existing prospectus disclosure to determine if it adequately addresses relevant risks. To the extent the UCITS is a "clone" of a U.S. mutual fund, the UCITS prospectus disclosure on Eurozone risks should be evaluated in light of the disclosure in the prospectus or statement of additional information for the U.S. mutual fund. A UCITS should review its prospectus disclosure with respect to temporary defensive positions, redemptions in kind, gating and suspensions.

- **Board Communication**: Fund management should ensure that there is open communication with the UCITS board (or its management company) and that an agreed-upon oversight process has been established. This process should include a means for intra-meeting communications in the event that a crisis worsens in advance of a planned meeting date. If they have not already done so, fund management and the board should also reach an understanding on how emergency communications should be conducted and the degree of delegation that will be permitted both within the board itself, as well as the extent to which the board is comfortable delegating to fund management the ability to take certain actions prior to receiving board approval in the event of a crisis. While some funds may be able to leverage off of prior experience with these types of crisis communication protocols, other funds may need to develop these types of processes for the first time.

- **Shareholder Communication**: UCITS advisers may wish to consider communicating to shareholders in a letter to investors, white paper, notice on the UCITS' website or other communication, some discussion of the potential Eurozone crisis and the steps that the UCITS has taken, or will be taking, to protect itself. 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. UCITS should also consider whether any such shareholder communication is required to be filed with a national regulator either in its home Member State or in a host Member State. As with U.S. mutual funds, UCITS also should consider and adhere to their portfolio holdings policy with respect to any communication with investors.

- **Marketing Materials**: UCITS marketing pieces should be reviewed to ensure that they include adequate risk disclosure regarding any material direct or indirect exposure to Eurozone risks. Personnel involved in reviewing marketing materials for funds should be sensitive to inconsistent messaging between marketing pieces and the prospectus for a UCITS and guard against overstatements in marketing materials regarding the degree to which a UCITS has been insulated from Eurozone risks.

- **Shareholder Reports**: Disclosure regarding potential Eurozone risks in a shareholder report should be considered with the input from the UCITS' auditor. Fund management may wish to discuss Eurozone developments, risks and their possible impact on the fund as a matter of shareholder relations.

- **Review of Derivatives Documentation/Currency Risk**: A break-up of the Eurozone would have widespread implications for Euro-denominated derivatives arrangements. UCITS should review the impact on the UCITS' portfolio and derivative documentation that the withdrawal of one or more countries from the Eurozone may have on currency swaps and options that involve the payment or delivery of Euro, whether by a non-Eurozone swap participant or by a counterparty seeking to hedge risks specific to a country that has ceased to use the Euro.

- **Sub-Custody and Operations Risk**: UCITS should review the liability provisions of their current custody contracts with respect to sub-custody risk. In addition, UCITS should begin a dialog with their custodian on contingency planning for the Eurozone and the operational challenges that will ensure clearance and settlement through SWIFT.

- **Class Restructuring**: UCITS should consider whether to add additional classes to the UCITS prospectus in planning for a potential Eurozone break-up and establish a dialog with its transfer agent on the costs, timing and mechanics of new class launches.

This *DechertOnPoint* will be followed by a Dechert white paper exploring in more detail the risks and action points noted above.

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