



FINANTSINSPEKTSIOON

## **REQUIREMENTS FOR THE MANAGEMENT OF RISKS RELATED TO THE INVESTMENT OF THE ASSETS OF A FUND**

The advisory guidelines have been enacted by the 12.08.2009 Resolution No nr 1.1-7/32 of the Management Board of the Financial Supervision Authority.

### **1. Competence**

In accordance with section 3 of the Financial Supervision Authority Act (hereinafter: "FSAA"), the Financial Supervision Authority conducts national financial supervision in order to enhance the stability, reliability, transparency and efficiency of the financial sector, to reduce systemic risks and to promote prevention of the abuse of the financial sector for criminal purposes, with a view to protecting the interests of clients and investors by safeguarding their financial resources, and thereby supporting the stability of the Estonian monetary system.

In accordance with section 57 of the FSAA, the Financial Supervision Authority has the right to issue advisory guidelines to explain legislation regulating the activities of the financial sector and to provide guidance to subjects of financial supervision.

### **2. Scope of regulation, purpose and application**

#### **2.1. Purpose**

- 2.1.1. In accordance with subsection 51 (6) of the Investment Funds Act (hereinafter: "IFA"), managers of an investment company shall ensure that the organisational structure of the investment company is transparent and has clearly specified responsibilities and that there have been established procedures for identifying, measuring, managing, constantly monitoring and reporting risks that are adequate and proportionate considering the nature, extent and degree of complexity of the investment company's activities.
- 2.1.2. In accordance with subsection 248 (1) of the IFA, a management company shall establish for the management of risks (hereinafter: "risk management") related to the investment of the assets of an investment fund (hereinafter: "fund") internal rules of procedure (hereinafter: "rules"), to enable at any time the monitoring and measurement of the risk of the positions and their contribution to the overall risk profile of the assets of the fund.
- 2.1.3. The purpose of the guidelines is to explain the requirements contained in subsections 51 (6) and 248 (1) of the IFA and, amongst other things, to direct a management company to apply

appropriate risk management measures. The guidelines help a management company to better understand the standard and good risk management practice in the relevant professional activity, which creates a greater precondition for the achievement of the best benefit in the interests of unit holders.

- 2.1.3. The guidelines have been drawn up on the basis of, amongst other things, the guidelines of Risk Management Principles for UCITS of the *Committee of European Securities Regulators*.

### **3. Scope of application**

- 3.1. The guidelines shall apply to a management company holding an activity licence issued by the Financial Supervision Authority in the administration of investment and pension funds. The application of the guidelines need not be limited to the foregoing, since the indications provided in these guidelines may also be appropriate in the administration of funds and securities portfolios of other types.
- 3.2. Application of the guidelines shall take into account requirements arising from legislation. In case of imperative requirements arising from legislation, provisions in legislation shall be taken into account.
- 3.3. In case of problems of implementation and interpretation in the application of the guidelines, the principle of reasonableness shall be taken into account in light of the purpose of these guidelines and in good faith with the diligence expected of a management company.
- 3.4. Application of the guidelines shall take into account the "comply or explain" principle in accordance with which a management company has to, if needed, be able to state grounds to a person entitled thereto why he or she is not implementing a clause in the guidelines or does it partially.

### **4. Definition of risk management**

- 4.1. For the purposes of these guidelines, risk management is the definition, identification, analysis, assessment, measurement, monitoring and management of a risk related to an investment planned or made out of the funds of a fund, and the decision making related to the foregoing.
- 4.2. The purpose of risk management is to identify and manage risks the realisation of which may express itself for a fund shareholder or fund unit holder in a reduction in the net value of a unit or which may result in the disruption of the orderly functioning of a fund.
- 4.3. For the purposes of these guidelines, an investment by a fund shall be taken to mean any transaction related to the investment activities by the fund, which may include a transaction in securities, deposit transaction, loan transaction, pledge transaction, transaction in other assets and the like.

4.4. Risk related to investments by a fund may derive, amongst other things, from:

- directly from investment activities (market risk, liquidity risk, credit risk, foreign-exchange risk, inflation risk, market concentration risk, volatility risk and the like);
- potential changes in the legal environment (tax risk, political risk, other changes bearing on the activities of a fund and the like);
- asset safe-keeping (risk of insolvency, destruction/loss of the assets of a depository, underwriter or depository of other assets or the risk of the abuse of other assets and the like);
- asset valuation (complexity of the fair valuation of investments off a regulated market, absence of a presentable quotation of assets and the like);
- operational risks (settlement system risk, risk of register maintenance and the like);
- conflicts of interests (transactions with persons linked to a management company or the presence of conflicts of interests with such persons, conflicting incentive schemes for managers and staff, membership of an independent treasurer in the same group as the management company).

## **5. General requirements for risk management**

5.1. A management company, in risk management, shall:

- ensure that the risk management solutions used within the firm are adequate and proportionate and match the nature, scale and complexity of the investment policy of a fund.
- act in good faith, employ appropriate professional skill, and exercise diligence and caution. Where in a management company's assessment in some instances its professional skill falls short, it shall seek such skill and knowledge from third parties;
- make investment related decisions under the conditions of adequate and appropriate information, assembling for this the required amount of information and analyse it with appropriate thoroughness from economic, financial and legal vantage points;
- owe a duty of care and loyalty to a fund's shareholder and unit holder; a management company's manager, fund manager and staff member shall act in the best interests of shareholders and unit holders;
- set the interests of a fund's shareholders and unit holders above its own interests and manage and avoid conflicts of interests, and, in the event of an unavoidable conflict

of interests, disclose the nature and source of such a conflict in the fund's prospectus;

- avoid transactions out of a fund's funds that do not accord with the fund's investment policy and objectives, jeopardise the orderly functioning of the fund or entail expenses not indispensable for the making or termination of an investment.

## **6. Requirements for internal risk assessment procedures**

- 6.1. A management company shall establish and implement appropriate legal, technical and organisational measures (internal procedures) guided by and adapted to risks deriving from transactions carried out under the investment policy of and out of the funds of a specific fund, taking into consideration the nature, extent and complexity of such risks.
- 6.2. A management company shall formalise its internal procedures in writing, and they shall be in conjunction readily identifiable, clear and transparent. Preferably, a management company shall compile its internal procedures into a stand-alone document. Internal procedures shall, amongst other things:
  - regulate risk management processes within a firm, its stages, decision-making powers and responsibilities;
  - enable a management company at any time to identify, monitor investment related risks and to manage them;
  - define the volume of information adequate and appropriate to the assessment of risks and the bases for the analysis of such information;
  - ensure the appropriate competence and skill of managers and staff involved in risk management;
  - regulate reporting related to risk management;
  - enable the efficiency of risk management within a firm;
  - ensure the subsequent identification of risk management measures (documentation).
- 6.3. The management board of a management company, in risk management, shall:
  - establish internal procedures and ensure that the management company's managers and staff operate in an environment of full awareness of risks and where risk considerations are taken into consideration to an appropriate degree in the fund manager's decision-making processes;

- evaluate regularly the efficiency, currency and appropriateness of the internal procedures and, if needed, decide the making of any changes required in the internal procedures;
- ascertain the risk profile of each fund and, where needed, alter it;
- provide itself with a regular overview of the information obtained in the course of the identification and measurement of risks;
- ensure that the risk profile of a fund disclosed to the fund's shareholders and unit holders is the case in actual fact;
- where needed, decide the initiation of changing a fund's investment policy.

## **7. Risk management unit**

- 7.1. A management company shall appoint a unit whose activities shall be supported appropriately with resources and whose managers or staff shall be of an adequate number and have the required skills, knowledge and expertise.
- 7.2. Preferably, a risk management unit shall be independent of other units in a management company and owe a reporting duty to the management board of the management company. If in a management company's estimation it is not possible or proportionate to have a stand-alone risk management unit, the management company shall nonetheless be able to demonstrate that specific protective measures against a conflict of interests permit independent action in the management of risks.
- 7.3. A risk management unit shall support the management board of a management company to identify all relevant risks with respect to the fund and to enable the on-going monitoring and measurement of these risks. A risk management unit shall implement methods and procedures required for the achievement of the above objectives, including the documentation of activities related to risk management, so that these may be identified later.
- 7.4. A management company shall ensure that between the risk management unit, management company's management board and fund manager regular communications channels are established in order for the risk management process to function effectively.
- 7.5. A risk management unit shall submit regularly reports to the management company's management board.

## **8. Outsourcing of tasks related to risk management to third parties**

- 8.1. A management company may, for the sake of efficiency, delegate the performance of risk management activities to a third party (outsourcee) by written agreement

- 8.2. If a management company has delegated the task of risk management to a third party (outsourcing), the management company shall ensure that compliance with these guidelines has been made mandatory for such a third party. A management company shall apply, in outsourcing tasks, the Financial Supervision Authority's guidelines on the "Outsourcing Requirements for Supervised Entities".
- 8.3. Outsourcing of risk management activities shall not impair the quality of the risk management process, supervision of which is performed by the management company's management board.
- 8.4. A management company shall employ all measures required to ensure that prior entering a written agreement with an outsourcee and later the outsourcee meets the requirements established by these guidelines with respect to the activity of the management company. Outsourcing of risk management activities should always be preceded by a technical audit concerning the systems, methods and information used by the outsourcee, and include information on any potential conflict of interests.
- 8.5. This section of the guidelines shall apply, amongst other things, to the conclusion of an agreement with a fund's independent treasurer (depository), to the extent of the risks addressed in these guidelines that are appropriate in light of the activities of the depository.
- 8.6. A management company shall ensure that an outsourcee has the technical ability and professional capacity to provide the outsourced activities reliably and effectively and in compliance with applicable laws and other regulatory requirements. Prior to entering an agreement with an outsourcee, a management company shall be satisfied that the outsourcee is able to perform the task outsourced to it.
- 8.7. A management company shall ensure adequate supervision of an outsourcee's activities and reserve right to terminate the agreement with the outsourcee, if needed, immediately. A management company shall ensure that a management company, its auditor and the competent supervisory agency are entitled to check the activities of the outsourcee.

## **9. Identification and measurement of risks**

- 9.1. The process of risk identification and measurement shall, amongst other things, be guided by (i) a fund's investment policy and the need to (ii) maximise the profit of the fund's shareholders and unit holders, (iii) achieve the smooth functioning of the fund in accordance with the provisions in the fund rules or articles of association and (iv) achieve preparedness for exceptional market events.

Amongst other things, the identification and measurement of risks shall take into consideration:

- fund's disclosed investment policy;
- fund's investment objectives;



- bases for the valuation of a fund's assets;
  - fund's liquidity requirement;
  - peculiarities deriving from the unit redemption solution and the associated obligations.
- 9.2. The process of risk identification and measurement shall be guided, at the least, by the risks enumerated in clause 4.4 of these guidelines.
- 9.3. Risk measurement techniques should be appropriate and proportionate to a fund's nature and complexity and integrated with both one another and the management company's appropriate adjoining solutions (asset valuation, reporting by managers and the like).
- 9.4. The process of risk identification and measurement shall not be of a static nature; it should be periodically reviewed to allow for possible changes to market conditions or the investment strategy. Where needed, over-reliance on set methodologies or specific risk management models (techniques, methods and technical instruments) should be avoided.
- 9.5. The risk measurement process should be structured so that it allows adequate assessment of the concentration and interaction of relevant risks at the fund portfolio level.
- 9.6. If a fund invests in complex financial instruments or financial instruments having no presentable quotation (non-marketable securities), a management company shall apply heightened diligence in the assessment of risks. Execution of transactions involving such instruments should be preceded by appropriate and thorough financial and legal analysis concerning the instrument, its underlying assets and the risks deriving from the instrument. Such analysis shall be documented.
- 9.7. If a management company uses model-based methods for the identification and measurement of risks, the management company should run tests to verify that model-based estimates and forecasts correspond, with the appropriate confidence level, to the actual values of the relevant risk measures (back-testing). Where appropriate, back-testing should be also carried out for the techniques used in risk measurement.
- 9.8. A management company shall carry out stress tests, the purpose of which shall be to ascertain the possibilities for rare and significant losses which could occur during market shocks, and which likely cannot be measured by the models created for normal conditions.
- 9.9. Stress tests should cover all quantifiable risks which affect, to a material degree, the value of a fund, with particular attention given to those risks which are not represented with sufficient accuracy by the risk models used. Such risks might include, for example, unexpected changes to price correlations or to the liquidity of assets (or the entire market).

- 9.10. In identifying and measuring risks, a management company shall take into consideration sound and reliable data. When measuring the risks of illiquid investments, a management company shall carefully check the robustness of its assessments.
- 9.11. A management company shall evaluate its risk measurement and management methods periodically, but not less often than once a year.
- 9.12. Requirements for the underlying data for risk identification and measurement and for their collection shall be established in internal procedures. Internal procedures shall involve the processing of all appropriate information and analysis, with this processing including the economy, finance and law.
- 9.13. A management company shall document operations related to risk identification and measurement, so that they may be identified later.

## **10. Management of a fund's relevant risks**

- 10.1. A management company's management board shall approve the risk profile of each fund administered by it.
- 10.2. A management company's management board shall establish for a fund, based on the provisions in clause 9.1 of these guidelines, a set of limits (the risk limit system) to maintain the consistency of risks with the risk profile.
- 10.3. A fund's risk profile shall reflect the degree of identified relevant risks deriving from the fund's investment activities and also their interaction and concentration at the portfolio level.
- 10.4. A limit system shall set appropriate limits for all potentially relevant risk factors. That is, it should cover all risks to which a limit can be applied and should take into account their interactions with one another. A management company shall ensure that every transaction is taken into account in the calculation of the corresponding limits.
- 10.5. In managing risks, a management company shall assess the consistency of identified relevant risks with the risk profile of a fund and ensure, in the event of deficiencies, the adoption of corrective actions. In order to achieve this objective, the process should be designed to trigger a prompt correction of the portfolio or other appropriate remedial action by a management company if the limits of a fund's target risks are exceeded. The appropriateness of the corrective actions as well as of their timing should be evaluated in the best interest of unit-holders.
- 10.6. The system of limits and related decisions shall be documented, so that they may be identified later.



## **11. Liquidity management**

- 11.1. A management company shall in case of each fund administered by it an appropriate liquidity management procedure and establish measures aiming to ensure the compliance of investments made out of the fund's funds to the obligations assumed out of the fund's funds or deriving from the fund rules.
- 11.2. The compliance of investments denotes a situation where a management company is capable, out of the funds of the fund's investments, perform in a regular and timely manner obligations assumed out of the fund's funds and the management company already when investing the fund's assets proactively allows for such potential obligations (including the management company allowing for the frequency of the obligation to redeem fund units, obligations deriving from loans and the like).
- 11.3. A management company shall ensure that a fund administered by it applies a fund unit redemption policy matching the liquidity profile of the fund's investments and vice versa.
- 11.2. A management company shall regularly carry out stress tests for both normal and exceptional market conditions and monitor the corresponding fund liquidity risk.
- 11.3. Operations related to fund liquidity shall be documented, so that they may be identified later.

## **12. Reporting**

A risk management unit shall submit regularly reports to the management company's management board, advising the level of risks that are part of a fund, their non-compliance, need to alter the risk profile and the like. The rules, content and frequency of reporting shall be defined in internal procedures.

## **13. Supervision of internal risk management procedures**

A management company's management board shall implement an internal audit system that is internal to the firm and functions regularly and the purpose of which is to ensure the compliance of the management company's activities with the internal procedures and adopted decisions at all levels of management and activity and which assesses the performance of risk management.

## **14. Final provisions**

- 14.1. The guidelines shall enter into force from 15.02.2010.
- 14.2. Subsequent to the entry into force of these guidelines, a management company shall immediately submit to the Financial Supervision Authority the internal procedures related to the implementation of these guidelines.