

Finance Latvia Association and Latvian Private Equity and Venture Capital Association

RECOMMENDATIONS

For better risk management in alternative investment
funds, attracting assets from pension funds

Used terms

AIF – Alternative Investment Fund

AIFM – Alternative Investment Fund Manager

Investment Transaction – Investment in a portfolio company by buying or selling stocks or shares, a loan, including a convertible loan, as well as a real estate transaction or funding of a business merger

Pension Fund – Manager of state funded pension scheme assets or a private pension fund

SPV – A commercial company created for a special purpose

Preamble

Pension funds invest assets in the AIF with the aim of achieving a return for their clients – individuals making contributions to investment or pension plans, respectively. Pension funds, in compliance with the limits and other provisions set out in regulatory enactments and investment plans (prospectuses), invest in the AIF's licensed or registered in different jurisdictions, including taking into account that the regulations and practices of each jurisdiction in the operation of the AIF may differ. An investment in the AIF may be high-risk, low-risk, high-return or moderate-return. The operation of the AIF is ensured by the manager's team and may involve additional risks related to management efficiency and risk control. Insufficient control of the AIF manager's activities may lead to a higher probability that all or a part of the assets invested by Pension Funds are lost. Consequently, it is justified for Pension Funds to impose such requirements on the AIFM that mitigate the risk of loss of assets, and therefore these recommendations are issued for better management of this risk. The recommendations have been developed by the Finance Latvia Association and the Latvian Private Equity and Venture Capital Association in cooperation with the Bank of Latvia.

Recommendations

1. The recommendations have been developed to set out minimum recommended standards for risk management that:
 - 1.1. the Pension Fund, as a prudent and diligent manager, should take into account to ensure that the AIFM ensures appropriate and professional risk management and management of conflicts of interest;
 - 1.2. the AIFM would comply with in its activities and at the level of each AIF.
2. The pension fund ensures, on a risk-based basis, and the AIFM proves that the AIFM acts in accordance with best market practices as set out in the Invest Europe Code of Conduct, as well as additionally takes into account the paragraphs below.
3. The Pension Fund, having concluded that the investment is in line with its risk appetite, investment strategy and the interests of the plan participants, in order to act as a prudent and diligent manager in relation to the AIFM:
 - 3.1. ensures the existence of the risk assessment and the policies, procedures or practices identified therein, using a focused ex post external audit report on internal control systems, which the AIFM submits to the Pension Fund once within 12 months after the Pension Fund has made an investment and no less than once every five years.
 - 3.2. may apply additional risk management measures, specifying them in the AIF investor's agreement.
4. The AIFM managing at least one fund with assets of at least 100 million euros has an independent risk control function (second defence line), which is performed by the member of the management board responsible for risk management. Such a member of the AIFM's management board guides in the AIFM's work primarily by the aspects of the independent risk control function and its opinions, in particular if they differ from the decision taken by the majority of the management board, are attached as an annex to the decision of the management board.
5. The member of the management board referred to in Paragraph 4 of the Recommendations:
 - 5.1. may combine the position with the position of a member of the management board of the AIFM responsible for managing the risks of money laundering and international sanctions;
 - 5.2. may combine the position with another position or function in the AIFM that includes risk control activities related to the use of assets, decision-making, management of the risk of conflict of interests, whistleblowing and valuation of the fund assets;
 - 5.3. may not participate in the operational work of the AIFM related to initiating investment transactions, assessing them from a business perspective and managing the portfolio company, but may be an investor in the fund.
6. The AIFM, with one or more funds constituting a smaller amount signed than specified in Paragraph 4 of the Recommendations, may designate one or more responsible employees instead of the respective member of the management board, following the approach that they are subordinate to the member of the management board responsible for managing the risks of money laundering and international sanctions. The requirements specified in Paragraph 5 of the Recommendations are not applicable to such a member of the management board. If, however, such a member of the management board combines positions with other functions within the AIFM, the risks of combining functions are managed

in accordance with the policy for prevention the conflicts of interest, ensuring the independence of employees subordinate to the member of the management board in the performance of their duties in situations of a conflict of interest of the member of the management board.

7. The AIFM conducts a risk assessment for each managed AIF (regardless of whether pension funds invest in all AIF of this manager) and updates it regularly, but not less than once every three years, ensuring that in each fund:

- 7.1. the most significant risks are identified;
- 7.2. the defined methods are used for risk assessment and, if possible, the risk level is determined, the risk level is monitored, including the level of unacceptable risk;
- 7.3. the measurable risk appetite is determined in the most significant risk areas (for example, in relation to the reputational risk management in relation to investors, investments, payments, fraud, legal risks);
- 7.4. the risk mitigation measures are provided for;
- 7.5. the individuals responsible for the risks are provided for;
- 7.6. the risk reporting is provided for;
- 7.7. the risk assessment updates are provided for;
- 7.8. the risk management infrastructure is established so that information relevant to risk management is collected and analysed.

8. The AIFM's management board and the SPV's management board have at least two members of the management board ensuring compliance with the four-eye principle in the event of significant decisions and action (e. g., signing of agreements, payment orders), without prejudice to other pre-checks or post-checks specified in the policies and procedures.

9. The AIFM determines the relevance threshold for additional approval of payments or transactions, excluding the possibility of one person carrying out significant transactions.

10. The AIFM, in at least one of the funds managed by which a pension plan investment has been made or an agreement has been signed for such a transaction, has implemented a policy and procedure for management of the conflicts of interest, and an effective whistleblowing channel has been implemented – internal, to the extent permitted by the size of the AIFM, and external. When developing a policy and procedure for the conflict of interest, at least the following is taken into account:

- 10.1. a conflict of interest is defined;
- 10.2. regular (at least once every two years) training of members of the management board and employees on conflict of interest is carried out;
- 10.3. a process for identifying, documenting and independently monitoring the conflicts of interest is provided for;
- 10.4. action is provided for in the situation of a conflict of interest;
- 10.5. updating of the processes of management of the conflicts of interest is provided for if the management structure or identifiable and measurable risks change;
- 10.6. allocation of responsibilities is provided for;
- 10.7. actions on transactions with related parties (persons) has been stipulated.

11. The AIFM ensures the due diligence checks not only on the AIFM and the management personnel, which are documented, but also on the SPV (if established in the real estate or infrastructure sector) and on portfolio companies in which the AIF has a decisive control.

12. When preparing the annual report, the audited annual report of the SPV (if established for a real estate or infrastructure fund) includes a sample review of the accounts of the

relevant SPV. This is applicable regardless of whether there is a legal obligation to prepare consolidated annual reports.

13. The Recommendations are applicable to new investment agreements concluded from 1 March 2025. The parties are not prohibited from agreeing that the Recommendations are also applicable to the agreements concluded after the issue hereof but before 1 March 2025.