

**RIVER AND MERCANTILE**  
ASSET MANAGEMENT

**Pillar 3 Disclosure Statement**

**Version 4.1**

**May 2010**

## **Introduction**

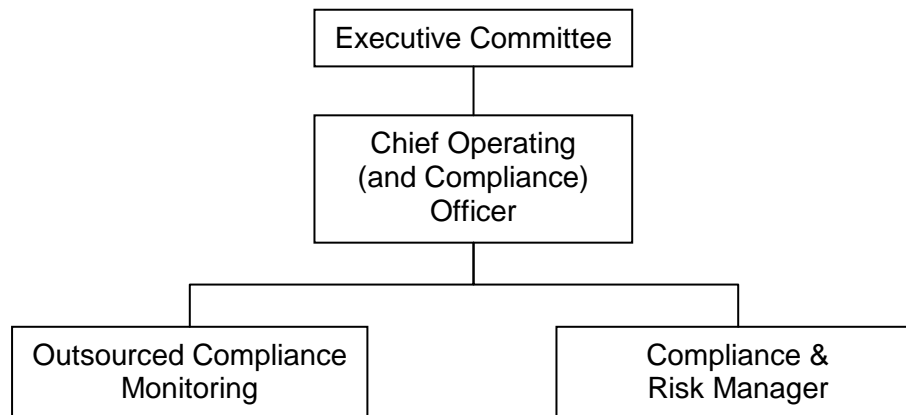
River and Mercantile Asset Management LLP (R&M) is categorised by the FSA as a BIPRU Limited License firm with a Base Capital Requirement of Euro 125,000. As such it is subject to the Capital Requirements Directive (CRD) and is required to make Pillar 3 disclosure.

R&M is not a subsidiary, nor does it own any subsidiaries, and hence all disclosures are shown on an individual partnership basis.

## Risk Management

### Governance

The LLP's risk management focuses on the major areas of market risk, credit risk and operational risk. Authority flows from the Executive Committee to the Chief Operating (and Compliance) Officer and from them to the Compliance and Risk Manager. R&M has also commissioned the services of an independent compliance consultancy, Hedgesupport LLP, who undertake formal quarterly compliance monitoring visits and provide ad hoc advice.



**Executive Committee:** this is the primary governing body. The committee determines the acceptability of risks that the Partnership faces and also determines the framework for mitigating these risks.

**Chief Operating (and Compliance) Officer:** the Executive Committee has given authority to the Chief Operating Officer regarding the ongoing management of risk. This includes the identification, assessment and reporting of risk.

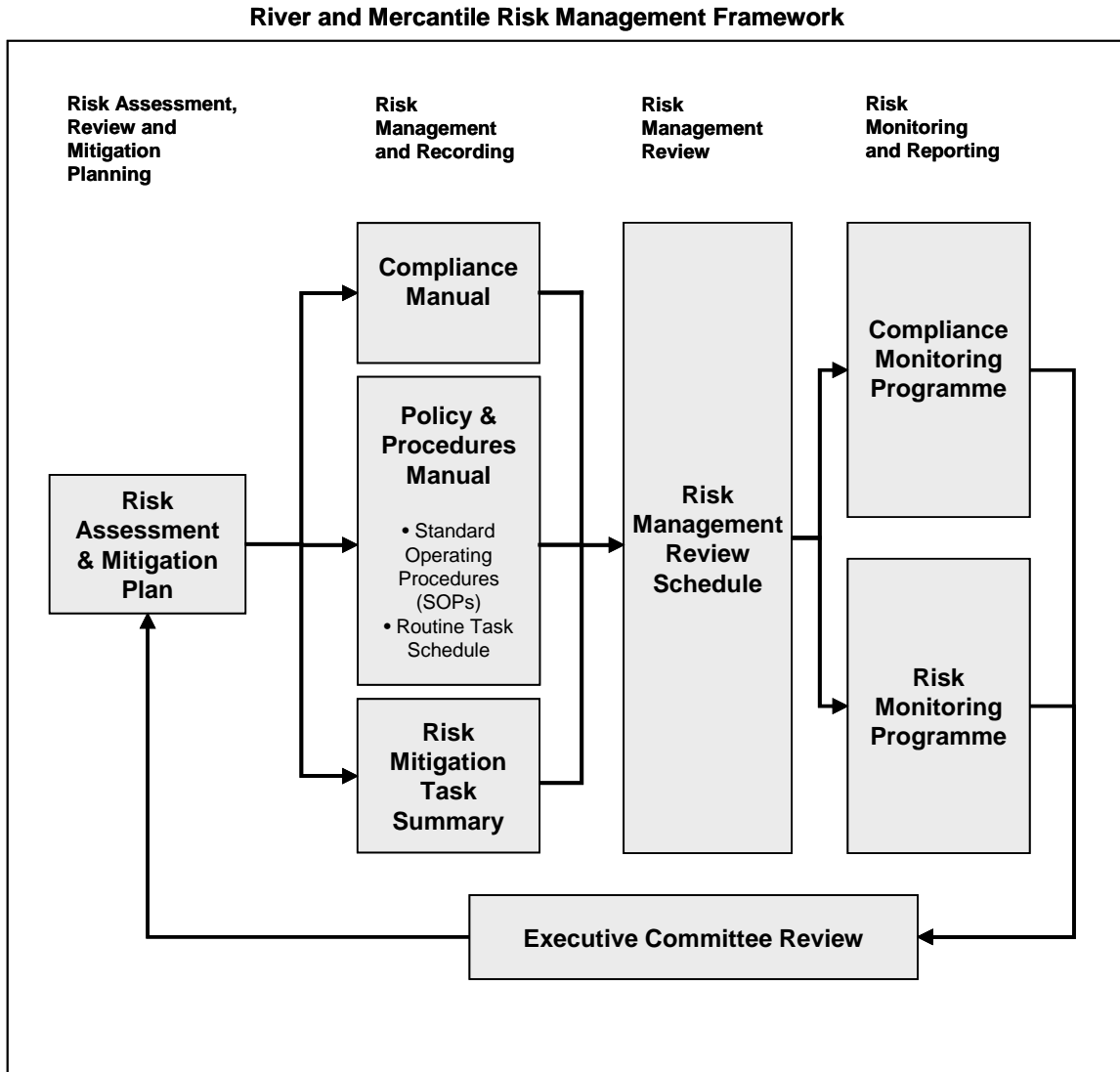
The Chief Operating Officer updates the Partnership's Risk Assessment and Mitigation Plan semi-annually to ensure the business is operating in accordance the risk appetite determined by the Executive Committee. The Chief Operating Officer also reviews the Partnership's Internal Capital Adequacy Assessment Process annually, but monitors Liquid Capital on a daily, monthly and quarterly basis.

**Compliance & Risk Manager:** has responsibility for ensuring policies and procedures determined by the Executive Committee are implemented. The Compliance & Risk Manager is also responsible for undertaking robust internal compliance and risk monitoring activities.

**Outsourced Compliance Monitoring:** on a quarterly basis Hedgesupport LLP, a third party compliance consultancy, undertake comprehensive compliance monitoring to ensure that the Partnership has been operating in accordance with the regulations.

## Risk Management Strategy

R&M operates a robust, comprehensive and integrated risk management strategy. The key components of the strategy are detailed in the risk management framework schematic below and described in more detail overleaf.



The policies, procedures and processes detailed in the above framework are rigorously implemented on a day to day basis and subject to quarterly monitoring and review.

### Risk Assessment & Mitigation Plan (RAMP)

The RAMP is the cornerstone of R&M's risk management framework. It is a detailed spreadsheet which identifies every risk faced by the business under the categories of Governance and Financial Control, Operations and IT, Investment Management and Distribution. Each category is split into sections and each risk under each section is evaluated under the following headings:

- Risk detail – describes the exact nature of the risk faced by R&M.
- Nature of the risk – considers the type of the risk (i.e. regulatory, reputational or prudential), the probability of the risk materialising (i.e. high, medium, low), the impact of the risk in the event it materialises (i.e. high, medium, low), and finally the severity of the risk (i.e. high, medium, low) which is the product of the probability x the impact.
- Risk mitigation – details who is responsible within the business for mitigating the risk, the operational procedures that are in place to mitigate the risk and reference to where these procedures are detailed in the Policy and Procedures Manual.
- Risk monitoring – details how the effective and timely execution of the risk mitigation procedures are monitored. Typically this monitoring will be part of the quarterly compliance monitoring programme undertaken by Hedgesupport, or part of the internal risk monitoring programme.
- ICAAP – determines whether each risk has a direct impact on R&M's capital requirements for the purposes of complying with the Capital Requirements Directive, categorises the nature of the risk in terms of R&M's ability to mitigate it and details the amount of additional Pillar 2 capital required to cover the risk.

The RAMP is formally reviewed on a semi-annual basis by the COO and the Compliance and Risk Manager.

#### Risk Mitigation Task Summary (RMTS)

The RMTS summarises all the risk mitigation tasks that are identified in the RAMP and detailed in the Policy and Procedures Manual (P&PM). Each task details responsibility, frequency, cross references to the RAMP and P&PM and where records are maintained of the task completion. The RMTS acts as the basis on which the internal Risk Monitoring Programme is undertaken.

#### Policy and Procedures Manual (P&PM)

The P&PM is the “bible” which details how R&M operates. As such it is a lengthy document, comprising of over 200 pages which is divided into five chapters. Each chapter is divided into sections within which details are provided of R&M's business policy and an overview of the business procedure. Where necessary the P&PM makes reference to the Standard Operating Procedures (SOPs) which provide very detailed guidance on how each procedure should be executed.

In addition to the SOPs there is a Routine Tasks Schedule which is an .xls spreadsheet which summarises all the key regulatory and mission critical activities undertaken within the business. For each activity the schedule details who is responsible, and provides a reference to the respective SOP. The spreadsheet enables the user to filter down by each member of staff exactly what their key responsibilities are so in the event of an emergency, unplanned leave, etc. any of covering member of staff can undertake the respective activity.

## Compliance Manual

R&M has engaged the services of Hedgesupport LLP to act as its compliance consultants advising and supporting our in-house team. Accordingly Hedgesupport have provided R&M with the framework for the compliance manual and provide periodic updates to the manual to reflect regulatory changes. As would be expected, the Compliance Manual specifies the regulatory requirements to which R&M must adhere to maintain its status as a body that is authorised and regulated by the FSA.

## Risk Management Review Schedule (RMRS)

The RMRS summarises all the risk mitigation tasks that are detailed in the RMTS, the P&PM and the Compliance Manual in terms of what should be done, when and by whom. These details are then input into a dedicated Microsoft Outlook account called Monitoring, Reporting and Review Schedule. From this Outlook account calendar reminders are sent to individuals throughout the business who are responsible for risk mitigation tasks.

## Compliance Monitoring Programme (CMP)

R&M are subject to formal quarterly compliance monitoring visits undertaken by Hedgesupport. This is a self-imposed discipline whereby an independent and impartial third party undertakes a series of rigorous tests to ensure R&M is fully compliant with the regulations. The findings of each visit are formally written up by Hedgesupport with any recommended action points. These action points are logged by R&M and the appropriate responses are then recorded and signed off by the CEO.

## Risk Monitoring Programme (RMP)

Any risk mitigation tasks and activities which are not a regulatory requirement, and hence not reviewed as part of the formal compliance monitoring, are reviewed as part of the internal Risk Monitoring Programme. The types of activities which are included in the RMP are quarterly client reporting, portfolio and performance alignment with product strategy model, servicing of the air conditioning unit in the server room, etc.

The RMP is undertaken on a quarterly basis by the Compliance & Risk Manager and a log is maintained of any outstanding actions. This log is reviewed at a weekly meeting held between the Compliance and Risk Manager and the COO and any remedial action is agreed. Once all the actions have been completed the quarterly review is signed off by the CEO.

## Executive Committee Review

R&M's Executive Committee meet on a six to eight weekly basis. The outcome of any CMP and RMP activity is reviewed along with any exceptional activities or incidents. Remedial action is agreed where necessary.

## Capital Resources

### Pillar 1 Capital

The Partnership's capital comprises solely of Tier 1 capital which equals partner's capital less audited reserves less material current year losses.

A summary of the Partnership's total capital as at 31<sup>st</sup> March 2010 is shown below:

	<b>£'000s</b>
Tier 1 Capital	
Partner's Capital	3,799
Audited Reserves	(904)
Excess of drawings over profits	(966)
 Total Capital Resources	 1,929

### Pillar 1 Risk Measurement

The variable capital requirement of the CRD is detailed in GENPRU 2.1.45. The components of the calculation which are relevant to R&M are detailed below.

#### Credit Risk Capital

Type of risk	Basis of capital calculation	Impact on R&M
Credit (BIPRU 3.1 and 3.4)	Firms are required to maintain capital equivalent to 8% of any cash deposits and trade debtors. However, a severity factor of 20% may be applied to this sum made for regulated banks and institutions which effectively reduces the capital required to 1.6% of for bank deposits invoice amounts outstanding to FSA regulated bodies.	R&M will typically have cash balances of £1,500,000 to £2,000,000 with Bank of Scotland which will require a capital resource of £24,000 to £32,000. Additionally R&M will accrue IMC for segregated accounts which one month after each calendar quarter may be in the region of £1,500,000 (based on seg acc AUM £1.35bn) which equates to an additional capital resource requirement of up to £24,000.
Counterparty and Settlement (BIPRU 14.2)	When acting as a counterparty for transactions with T+4 settlement, as R&M does when acting as ACD, a firm is required to make a credit risk provision as stated above. Furthermore, if settlement is delayed for between 5 and 15 business days after the settlement date (SD) a capital provision of 8% of the mark to market difference is required in accordance with BIPRU 14.3.3.	It is unusual for R&M to have an aggregate position of unsettled ICVC investments in excess of £500,000, and the firm retains a "settlement float" of £1,000,000 to accommodate late settlement. Assuming ICVC share price declines under normal circumstances would not decline by more than 10% between T and SD +15 and R&M's investors are FSA regulated, R&M's typical Counterparty and Settlement Risk capital requirement would be £500,000 x 8% x 20% plus £500,000 x 10% x 8% which totals £12,000

In addition to the Credit and Counterparty and Settlement risk, a firm must also monitor its Large Exposures. BIPRU 10.5.6 states that a firm must ensure that its total non-trading book exposure to a single counterparty (e.g. outstanding investment management fees) does not exceed 25% of its capital resources. R&M monitors large exposures at each month end and will take appropriate action where necessary.

#### Market Risk Capital

Type of risk	Basis of capital calculation	Impact on R&M
Equity Position Risk (BIPRU 7.3)	Firms are required to maintain capital equivalent to 12% of any equity positions held on the balance sheet as liquid assets.	As the Authorised Corporate Director of R&M Funds ICVC the firm maintains a "Box" position of approx. £250,000 which is categorised as a liquid asset. Accordingly R&M needs to retain EPR capital of approximately £30,000.
Foreign Currency Position Risk (BIPRU 7.5)	Firms are required to maintain capital equivalent to 8% of any foreign exchange positions held on the balance sheet as liquid assets.	As at 31/03/10 R&M held a nominal balance of USD1,000. Accordingly R&M needs to retain FCPR risk capital of approximately £50.

#### Fixed Overhead Requirement

Type of risk	Basis of capital calculation	Impact on R&M
Fixed Overhead Requirement (GENPRU 2.1.53)	Firms are required to maintain capital equivalent to 25% of their fixed annual audited expenditure. This calculation excludes costs as per GENPRU 2.1.53 (e.g. bonus payments, partners drawings, etc.). GENPR 2.1.56 requires the firm to amend the FOR if current fixed annual expenditure is materially higher than the previous year's audited fixed annual expenditure.	R&M's fixed annual audited expenditure to March 2010 is £2,230,000. However, making adjustments for bonus payments, interest payments, etc in accordance with GENPRU 2.1.54 R&M's FOR is £541,000.  Note - the FOR also acts as a proxy for the "cost to close". See below for R&M's "cost to close" assumptions.

#### Pillar 1 Capital Requirement

The Pillar 1 capital requirement is the higher of the aggregate of the market and credit risk requirement and the fixed overhead requirement. R&M's Pillar 1 actual capital requirement as at 31<sup>st</sup> March 2010 is shown below:

	£'000s
Creditor Risk	56
Counterparty Settlement Risk	12
Equity Position Risk	30
FX Position Risk	1
<b>Total Pillar 1 capital risk</b>	<b>99</b>
<b>Fixed Overhead Requirement</b>	<b>479</b>

Based on the above figures the Pillar 1 capital resources requirement is 479,000, hence as at 31<sup>st</sup> March 2010 R&M had a Pillar 1 capital resources requirement surplus of £1,567,000.

## **Pillar 2 Risk Measurement**

In the context of the UK's financial services industry and the firms authorised and regulated by the FSA, R&M is a small and simple business. R&M's sole business activity is long only investment management which is undertaken on an entirely discretionary basis for Professional Clients and R&M Funds ICVC. The firm does not provide advice to Retail Clients, and critically does not take market positions or act as principal in any transactions. Additionally the firm does not lend money in any capacity to third parties, and hence its only creditors are investors into the R&M Funds ICVC where settlement is accepted on a T+4 basis and Professional Clients where periodic investment management charges accrue on a quarterly basis.

Overall, R&M has a very low risk appetite and, as described in the Risk Management Framework section above, has gone to extensive lengths to adopt best practice and mitigate and minimise those risks which exist within the business. However, as a financial services firm inevitably certain risks exist which cannot be completely negated. These risks can be characterised under the three headings below.

### Loss of revenue

The nature of the investment management business is that a very high percentage of the cost base is fixed. As such, if revenues decline the firm's costs will not materially decrease and the firm may become loss making. The key drivers of revenue are assets under management (AUM) and investment management charge (IMC) margin. AUM are a function of net asset flows and equity market movements. The IMC margin is a function of the nature of the fee negotiated with the clients i.e. is it fixed or performance related, and if it is performance related on how well the assets perform relative to the respective benchmark.

Whilst R&M can obviously take various steps to maintain and drive its revenue, it cannot ultimately control asset flows, equity market movements and portfolio performance. However, R&M's philosophical approach of broad diversification in its Fund Management and Distribution functions should ensure that the business will become relatively immune to a collapse in anyone business area i.e. retail or institutional support.

### Counterparty and Settlement Risk

As the Authorised Corporate Director (ACD) of the R&M Funds ICVC the firm deals with investors into the various sub-funds on a T+4 basis i.e. investors place orders to purchase shares in the ICVC for settlement on T+4. However, R&M also has a regulatory requirement to settle these respective purchases with the ICVC's Depository on T+4, and hence if funds have not been received the underlying investor R&M is liable for the settlement with the depository. Accordingly, in accordance with BIPRU 3.4, R&M must retain sufficient capital to cover the risk of default or late settlement.

The vast majority of R&M's material investors are "institutions" as defined by the FSA regulations and hence the risk of default is very low. Additionally R&M has internal policies which limit the size of any T+4 investment, and any investment over this limit will be reviewed on an exceptional case-by-case basis.

The risk of default and late settlement is low, however the size of the investments of the various institutions which invest in sub-funds can be very substantial (i.e. £5+ million). Consequently, although R&M can materially reduce counterparty and settlement risk through the adherence of tight management policies, the capital resource requirement is material as the risk of default or late settlement cannot be completely negated.

### Negligence, Fraud and Wilful Default

R&M's clients place enormous trust in the firm to manage and administer their investments whilst operating in the capacity of discretionary investment managers. With this trust comes great responsibility to operate with the utmost care and attention to ensure the prescribed policies and procedures are in place and adhered to. Whilst R&M has gone to considerable lengths to develop and implement a robust and comprehensive risk management strategy, the firm can never fully negate human errors, fraud or wilful default.

Whilst R&M cannot fully discount the risk of fraud or wilful default, in reality negligence is the most likely eventuality of the three risks. Examples of negligence include, but are exclusively limited to:

- Dealing errors – issuing instructions, typically by telephone, to the market makers which are either wrong stock, wrong way or wrong quantity.
- “Fat fingers” – inputting a deal into the system incorrectly, typically by adding an extra zero, and hence increasing the order by a factor of ten.
- Position reconciliation – failure to correctly reconcile equity positions which may result in short selling and having to buy stock back at a loss.
- Instruction authentication – failure to properly authenticate a client instruction with an authorised signature which may result in the client losing money or third party fraud.

Although R&M has extensive policies and procedures in place to mitigate these and many other risks, the risk of negligence, fraud and wilful default can never be fully discounted. Accordingly R&M has comprehensive Directors and Officers and Professional Indemnity insurance in place with a limit of £5 million and £10 million respectively – a level deemed more than appropriate by insurance brokers given R&M's current asset base. Both policies have an excess fee of £100,000 and are reviewed on an annual basis.

### **Pillar 2 Capital Requirement**

As mentioned above, Pillar 2 is contingency capital that R&M needs to retain for a worst case scenario which materially impacts the Partnership's Profit and Loss account. The table below summarises the capital requirement impact on R&M of the various eventualities which occur independently, or may be correlated and happen simultaneously to conspire into a worst case scenario.

Type of risk	Basis of capital calculation	Impact on R&M
Loss of Revenue (due to AUM attrition and market decline)	The firm's Total Capital Resource is the total of Partners Capital (GENPRU 2.2.94) less Audited Reserves less Material Current Year Losses (GENPRU 2.2.85).	In the event that R&M suffers a loss of revenue this may incur Current Year Losses and increase Audited Losses, thereby reducing the firm's capital

	R&M has stress tested its Capital Resources Requirement surplus through its ICAAP by forecasting scenarios around severe market price declines, severe asset inflow declines and the loss of key institutional mandates.	resources. Under the various scenarios tested against the firm's Base Case 3 Year business plan, in the Worse Case the firm's surplus Capital Resources decline to £1.206m, £1.087m and £1.087m respectively at the FYE March 2011, 2012 and 2013. See Chapter 5 for details of scenario calculations.
Counterparty and Settlement Risk	R&M's current policy is that it will accept T+4 settlement for ICVC investment deals from regulated institutions up to a maximum of £5 million, but it will cancel and reverse any deal that is not settled within 15 working days of the settlement date or if the ICVC share price falls by more than 10% below the execution price. The firm assumes the maximum ICVC share price decline 15 business days after the due settlement date is 10%. R&M's policy is that any ICVC investments over £5 million will be considered on a case by case basis.	For R&M to have the flexibility to accept deals of up to £5mn for FSA regulated firms and £1mn for all other investors it must retain credit risk capital of the higher of £5mn x 8% x 20% or £1mn x 8% which equals £80,000. Additionally the firm needs to retain market risk capital £5mn x 10% x 8% which equals £40,000, making a total of £120,000. Investments over £5mn for FSA regulated firms or £1mn for all other investors will be reviewed on a case by case basis, and will typically require a client indemnity to cover any interest charge incurred on R&M as a consequence of late settlement and the potential capital loss in the event of non-settlement and the client's position having to be liquidated.
Negligence, Fraud and Wilful Default	R&M maintains Directors & Officers and Professional Indemnity with limits of £5 million and £10 million respectively to cover any liability in the event of a legal action taken against the firm for negligence, fraud or wilful default.	The R&M policies have an excess of £50,000 which the firm is required to maintain as capital.

In summary, the near term the Pillar 2 capital requirement is the higher of the firm's counterparty and settlement risk and operational risk requirements:

**£'000s**

Pillar 2 Counterparty and Settlement Risk	120
Pillar 2 Operational Risk	50

R&M was initially capitalised with Partners Capital of £2,770,000 in September 2006 with a further £250,000 injected in January 2008. To accommodate the launch of the Global Equity Division and various loss of revenue scenarios an additional capital injection of £785,000 was made in July 2009. A review of the ICAAP in April 2010 evidenced that no further capital is required to support a "Worse Case" scenario, and indeed the firm has sufficient capital to sustain materially more challenging scenarios than the "Worse Case".