

MEMO# 21422

August 1, 2007

Comment Requested on Current Draft of Risk Principles for Asset Managers

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TO: INTERNAL AUDIT ADVISORY COMMITTEE No. 5-07 RE: COMMENT REQUESTED ON CURRENT DRAFT OF RISK PRINCIPLES FOR ASSET MANAGERS

The Buy Side Risk Managers Forum (BSRMF) and Capital Market Risk Advisors have recently published a working draft of a paper, “Risk Principles for Asset Managers.” [\[1\]](#) This document, which is attached and briefly summarized below, is intended by the BSRMF to set forth “good general principles of risk management” for asset management organizations. The BSRMF has asked the Institute to provide comments or observations on the paper. In addition to the ICI, the BSRMF has sought comments from federal regulators (i.e., the SEC, CFTC, and FSA) and prominent institutional investors.

The Institute expects to respond to the BSRMF’s request for comments on the paper. To determine what those comments should be, we plan to discuss this draft at the September 19th meeting of the Institute’s Risk Management Advisory Committee. [\[2\]](#) If you are unable to attend the meeting, please provide me your comments on the draft no later than Tuesday, September 18th by phone (202-326-5825) or email (tamara@ici.org).

Overview

According to the BSRMF, a new set of general principles of good risk management is warranted because the asset management industry’s understanding of risk has continued to evolve as a result of market, economic, and technological developments. In addition, there is a growing appreciation among asset managers and other market participants that a better understanding of the relationship between risk and return can enhance investment performance. Unlike previous work in this area, the BSRMF’s new principles have been specifically drafted from the perspective of providing guidance to traditional asset management firms to assist them in developing and assessing their risk management programs.

The paper stresses that buy side firms differ greatly in terms of their size, complexity, product mix, client type, and legal and regulatory structure. Accordingly, “what is

appropriate for one firm may not be appropriate for another.” With this in mind, the BSRMF’s principles are not intended to be prescriptive. Instead, “each firm must determine whether and to what extent” the principles make sense” in light of a firm’s unique characteristics.

In addressing those principles that are typically relevant to buy side firms, the paper covers three main areas: governance risk, investment risk, and operational risk.

Governance Risk Principles

This portion of the paper covers those risk principles that relate to an organization’s structure and oversight and its need for independent controls, segregation of functions, senior management involvement in risk management and oversight, and the adoption of appropriate policies and procedures. The risk principles discussed in detail in this section include the following:

- Effective risk governance as an important component of effective risk management.
- Understanding and managing risk as the responsibility of everyone within an organization. Employees at every level should be cognizant of risk and do their part to manage those risks within their sphere of responsibility consistent with the firm’s policies.
- Control groups – such as risk management, credit, legal, compliance, and internal audit – play a vital function in the asset management business and they should have sufficient independence to be able to perform proper monitoring.
- The incorporation of a fiduciary mindset into a firm’s culture is a risk control and fiduciary obligations should be clearly understood by employees and clients alike.
- The organization’s risk profiles, values, and “tone” should be regularly communicated to employees with senior management requiring adherence to the organization’s risk values by themselves and their subordinates at all times.
- Any written policies, procedures, ethics codes, and guidelines should be realistic, clear, and unambiguous on their face, and require little or no interpretation on the part of the organization’s employees.

Investment Risk Principles

In the section of the paper dealing with investment risk, the following principles are discussed:

- Investment performance, investment risk, and liquidity risk should be regularly measured and monitored.
- Concentration risks and those risks attributable to leverage – including embedded leverage – should be tracked and understood.
- Client risk tolerances and expectations (both lower and upper bounds) – such as those derived from explicit quantitative and qualitative guidelines, and any written and oral representations – should be known and monitored and asset managers should have the capacity to monitor such guidelines and expectations before agreeing to do so.
- Valuation methodologies should be fair and consistent. This may be achieved, for example, through the use of objective third-party sources to price instruments in client portfolios or the use of a valuation committee to oversee the firm’s procedures for valuing portfolio instruments.
- To avoid placing too much reliance on a single statistical tool, it may be advisable for

asset managers to use a variety of statistics that quantify different aspects of investment risk.

- Regardless of the method chosen, stress testing is an important tool in analyzing risk.
- Capacity should be taken into consideration in accepting new investments and in equitably sharing limited opportunities with existing investors.

Operational Risk Principles

With respect to operational risk, the paper discusses the following principles:

- Firms should consider creating both a process that monitors and tracks the various elements of operational risks over time – including errors and mistakes that can be made in the ordinary course of business or during a disaster – to identify trends that could be an early warning sign of trouble and they should implement an exception/escalation process.
- It is appropriate for a firm to review, on a periodic basis, its systems, processes, and resources to ensure their adequacy and proper utilization.
- The use of spreadsheets and other end-user tools that are utilized for those products and instruments that cannot be processed by a firm's existing computing and accounting systems should be reduced and/or controlled because they may produce risk by not being subjected to careful vetting and testing. When the use of such end-user tools are necessary, some level of independent review and control should be considered.
- Models used by asset managers (e.g., for investment decisions, portfolio valuations, tracking limits and guidelines, or analyzing business strategies) should be assessed and validated at the time of their initial development or use and regularly thereafter, including when there is a significant change in market conditions, and the assessment should be documented.
- Firms should have adequate backup and disaster recovery and it is important for key employees to have access to backup and disaster plans at the office, their home, their car, other remote locations, and ideally through an internet site. Such plans should consider the impact a disaster may have on both the firm and its key suppliers and services providers.

Miscellaneous Principles

The paper also discusses principles relating to each of the following:

- The importance of tracking and managing issuer and counterparty credit risk on an aggregate basis;
- Managing risks pertaining to due diligence reviews, including those conducted of the firm and by the firm;
- Determining and tracking the firm's risk profile and tolerance to ensure that risk exposures are measured, managed, and reported on a regular basis as well as when significant market moves occur. This may involve determining whether to aggregate market and concentration risks at the enterprise level and aggregation of counterparty exposure across products and other relationships with the lender; and
- The consideration that should be given to the compliance, operations, legal, and systems risks prior to launching new products or strategies to reduce the risks associated with such product or strategy. This is particularly important given the fact that the asset management world is constantly evolving and developing new products

and strategies.

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[Attachment](#)

endnotes

[1] The BSRMF is a group of heads of risk management and chief risk officers from traditional buy side firms. The co-chairmen of the BSMRF are also the co-chairs of the Institute's RMAC and the BSMRF and the RMAC have many members in common.

[2] See Institute [Memorandum](#) to Risk Management Advisory Committee No. 2-07 [21420], dated August 1, 2007, for more information about this meeting.

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