

MEMO# 21877

October 22, 2007

Director of SEC's Investment Management Division Encourages Fund Firms To Focus On Operational Risk

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TO: RISK MANAGEMENT ADVISORY COMMITTEE No. 6-07 RE: DIRECTOR OF SEC'S INVESTMENT MANAGEMENT DIVISION ENCOURAGES FUND FIRMS TO FOCUS ON OPERATIONAL RISK

In his comments before the Investment Company Institute's 2007 Operations and Technology Conference, the Director of the SEC's Division of Investment Management, Andrew ("Buddy") Donohue, discussed, in part, the need for mutual fund complexes to focus on operational risk. [\[1\]](#) Although he was invited to speak on regulatory issues, [\[2\]](#) Mr. Donohue first turned his attention to operational risk, an issue he described as one that had recently captured his attention. Indeed, the largest portion of his speech was dedicated to this topic. His remarks relating to risk included the following observations:

- Risk management is becoming more and more important due to the intersection between technology and operations, as well as its impact on the way business is conducted in the fund industry. Due to the interconnectivity of operational systems, one small error – such as wrongly entering one digit of a code – can magnify to such an extent and at such incredible speed that the results can be “catastrophic.”
- A good place to start addressing operational risk is rethinking how we approach risk management in general. Mr. Donohue noted that using a historical approach might have been appropriate in the past, when risks were narrowly defined and generally known. Today, however, operational contingencies cannot always be categorized and losses can result from a complicated mix of events, making it hard to predict or model contingencies. He likened applying yesterday's approach to risk management to today's complex systems as “driving down a winding mountain road at top speed . . . using the rearview mirror to guide us!”
- Fund complexes should be thinking about whether all the business and operational

areas that are needed to grow and develop together are, in fact, keeping pace with each other. As an example, Mr. Donohue discussed the increasing complexity of investment products, such as credit default swaps, whose value has grown 240% in the past 18 months, to a total of \$34 trillion. He noted that while firms' traders and portfolio managers may have the sophistication to invest in these products, a firm that is relatively new to the area may not have enough experienced personnel in other areas, such as managing the documentation, settlement, valuation, and confirmation processes. He additionally noted that, in one article he read, it was estimated that 20% of electronic communications for credit default swaps failed because the trade data, which is entered into internal systems manually, had not been entered correctly.

- When firms utilize a "vertical" approach to their operations, they maintain control over all aspects of their operations; coordination among all the parts of the operations process is easier to achieve and responsibility is clear. Mr. Donohue noted, however, that the trend is toward a more "horizontal" structure, with critical functions increasingly contracted to third parties. In his view, this creates gaps within the operational process "and perfect coordination becomes more difficult. For this reason, the processes and controls that firms put into place must take into account the relationships among each contracting party to determine whether they are effective." It also requires ensuring that necessary communication between interconnected functions occurs, and when an update is made in one area, all affected functions are aware of the change.

Mr. Donohue concluded the portion of his remarks dedicated to the issue of risk by noting that, "[i]n the mutual fund area, I think we are just at the beginning of seeing growth mismatches of these types as technology continues to drive and reshape the fund industry as we know it."

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endnotes

[1] His remarks are available on the SEC's website at:
<http://www.sec.gov/news/speech/2007/spch101807ajd.htm>.

[2] The regulatory topics he discussed after his comments relating to risk were: 12b-1 fees; disclosure reform and interactive data; soft dollars; and books and records.