CFA INSTITUTE
Centre for Financial Market Integrity

The Committee of European Securities Regulators
11-13 avenue de Friedland
75008 Paris
France

17th October 2008

Risk Management Principles for UCITS

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") welcomes the opportunity to comment on the Committee of European Securities Regulators ("CESR") consultation on "Risk Management Principles for UCITS" (the "Consultation").

The CFA Institute Centre[1] promotes fair, open, and transparent global capital markets, and advocates for investors' protection. We attach great importance to the Undertakings for Collective Investment in Transferable Securities ("UCITS") Directive, which establishes the common framework for laws, regulations, and administrative provisions relating to retail investment funds in the European Union.

The Consultation forms part of the European Commission's efforts to revise the UCITS Directive through a package of legislative amendments. Specifically, the Consultation seeks to address the limitations of existing legislation through proposals to create a clear framework for risk management. Presently, risk management provisions for asset managers are contained within both the UCITS Directive and the Markets in Financial Instruments Directive (MiFID). However, the limited nature of these provisions may obfuscate the importance of risk management practices for UCITS funds. Accordingly, the introduction of guidelines and principles to form a clear framework for the risk management process are welcome.

The CFA Institute Centre fully supports CESR's efforts to improve risk management practices. In light of the wider range of securities that UCITS funds may now invest (following the implementation of UCITS III), and having regard to recent financial market turbulence, the need for strengthened risk management has been brought into focus. A transparent, robust framework for managing risks is of key importance to protect investors' interests, maintain confidence in the UCITS brand, and to ensure the integrity of retail investment funds within the European Union.

The Consultation proposes "level 3" measures. These address the areas of supervision, governance and organisation, identification and measurement of risks, management of these risks, and reporting and monitoring. The CFA Institute Centre is supportive of the

[1] The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

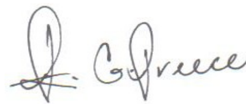
Charlottesville New York Hong Kong London
10th Floor, One Canada Square
Canary Wharf, London E14 5AB
United Kingdom
+44 (0)20 7531 0750 tel
+44 (0)20 7531 0767 fax
infoeu@cfainstitute.org
www.cfainstitute.org

proposals relating to each of these areas, which focus on clear written policies, accountability on the part of Directors, appropriate oversight, and robust statistical techniques for identifying, measuring, and managing risk.

Given the importance of risk management in protecting investors' interests, we also hope that CESR give due consideration to expanding the scope of risk management principles to cover other retail investment products. In order for these products to be fully "substitutable", as is the Commission's aim, it is necessary for a harmonised risk management framework to be put in place.

We attach our response that addresses the proposals of the Consultation. Please do not hesitate to contact us should you wish to discuss any of the points raised.

Yours faithfully,



Charles Cronin, CFA
Head, CFA Institute Centre,
Europe, Middle East and Africa

+44 (0)20 7531 0762
charles.cronin@cfainstitute.org

Rhodri G. Preece, CFA
Policy Analyst, CFA Institute Centre,
Europe, Middle East and Africa

+44 (0)20 7531 0764
rhodri.preece@cfainstitute.org

CFA Institute | Centre for Financial Market Integrity

The CFA Institute Centre is part of CFA Institute[2]. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

Our detailed comments follow the order of the Consultation's proposals.

"Questions for consultation: Do you agree with CESR's proposals? If not, please suggest alternatives."

1. Supervision

Box 1: Supervision by competent authorities
1. The adequacy and efficiency of the risk management process should be considered by the competent authorities as part of the process for licensing the UCITS/Company, and subsequently monitored on an ongoing basis.

Risk management is of key importance in protecting investors and maintaining the integrity of the UCITS product. Therefore, it is only appropriate that the adequacy and efficiency of the risk management process be monitored by the competent authorities on an ongoing basis. The proposals noted in Box 1 recommend first that the risk management process be considered by the competent authorities as one of the factors that determine the licensing of the UCITS/Company[3].

Whilst we do not object to this proposal, it is not clear from the Consultation how this should be applied to UCITS funds that are already licensed and marketed in Member States. It is appropriate for supervisory authorities to monitor the risk management process on an ongoing basis (i.e both prior to and post authorisation of the UCITS fund), however it should not be the case that the UCITS/Company need re-apply for licensing under these proposals. For clarity, the principles for supervision should first emphasise the importance of ongoing monitoring of risk management by competent authorities. Secondly, the principles may then address the adequacy of the risk management process in determining the licensing of new UCITS/Companies. To this end, it would be helpful to provide guidance that sets out how the competent authorities define 'adequacy and efficiency' of the risk management process. This would help establish a common basis for such licensing decisions.

2. Governance and organisation of the risk management process

Box 2: Definition of roles and responsibilities

[2] CFA Institute is best known for developing and administrating the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

[3] The Consultation defines "Company" as a UCITS III management company or self-managed investment company.

1. In order to fulfil the duty to identify, measure and manage the risks relevant to UCITS, Companies should structure, operate and maintain an adequate and proportionate risk management process, whose functioning and organisational rules should be established as part of the organisational rules adopted by each Company.
2. The risk management process should be appropriately documented, formalised and traceable in the procedures and organisational rules of the Company. The corresponding documents will be referred to as "risk management policy".
3. The risk management policy is approved, reviewed on a regular basis and, if necessary, adjusted by the Board of Directors.
4. The Board of Directors should be held accountable for the appropriateness of the risk management systems and procedures.

The CFA Institute Centre is supportive of these proposals. A formal, written risk management policy that sets out roles, responsibilities, and operating procedures establishes a robust and transparent framework for managing risk. Moreover, a formal risk management policy ensures that there is appropriate segregation of duties, effective utilisation of resources, and accountability. We welcome the emphasis on the accountability of the Board of Directors for the appropriateness of the risk management systems and procedures. This ensures that those charged with governance give due consideration to the risks faced by investors, and consequently that Directors' decision-making processes are aligned with the best interests of the fund's shareowners.

We also support the flexibility of these proposals, which provide clear guidance without burdening Companies with prescriptive measures. In particular, we are supportive of the provision in paragraph 7(d) (in relation to Box 2), which stipulates that the risk management policy should *"define the terms and frequency of risk management reporting to Senior Management and to the Board of Directors of the Company."* This ensures that there are clear reporting guidelines whilst allowing the Company to make its own determination of the terms and frequency of such reporting.

Box 3: The risk management function

1. Companies should specifically identify the relevant unit, department or personnel in charge of carrying out the risk management tasks (the risk management function).
2. The risk management function should be hierarchically and functionally independent from the operating units, where appropriate and proportionate in view of the nature, scale and complexity of the Company's business and of the UCITS it manages.
3. The risk management function should implement the risk management policy and procedures and report directly to the Board of Directors and Senior Management. It should operate in accordance with adequate standards of competence and efficiency.

The proposals contained in Box 3 principally relate to segregation of duties and accountability. In accordance with Box 2, we welcome the emphasis on the accountability of the Board of Directors for the Company's risk management policy. We are also supportive of the segregation of the risk management function from the other operating units, which should strengthen the accountability of that business unit to the Board.

Paragraph 14 of the Consultation elaborates on point 2 in Box 3:

> *"Where it is not appropriate or practical to have a separate risk management function, the company should nevertheless be able to demonstrate that specific safeguards guarantee that risk management is carried out with an adequate level of independence."*

This permits companies a degree of flexibility in structuring their risk management operation. This helps ensure that the proposed framework does not impact disproportionately on smaller companies, who may find it costly to establish a separate risk management function when their scale of operations may not merit a separate function. Accordingly, this provision safeguards the independence of the risk management process whilst avoiding burdening smaller companies with measures that could be anti-competitive.

We also note that an important aspect of effective risk management is communication between the portfolio managers and the (separate) risk management function. For the risk management process to work effectively, it should not operate in isolation without appropriate understanding of the risks arising through the investment decisions of the portfolio manager. Consequently, regular communication channels between these two parties are necessary for the risk management process to function effectively.

In order to mitigate operational risk, it is important that risk management personnel are endowed with sufficient skills, knowledge and ability, in addition to IT systems that are commensurate with the level of complexity embedded in the investment policy of the UCITS fund. We are therefore supportive of the principles contained in paragraphs 8 and 9 of the Consultation, which address these areas. In addition, we recommend that the compensation of risk management staff be independent of the performance of the fund, in order to reduce potential conflicts of interest, and thus safeguard the integrity of the risk management process.

Box 4: Outsourcing

1. Outsourcing of risk management activities does not exempt Companies from retaining full responsibility for the effectiveness and appropriateness of the risk management process.
2. The Company should properly and effectively supervise the carrying out of the outsourced activities. The Company should establish procedures for the periodic assessment of the Outsourcer's governance, technical and business environment, in order to monitor the quality and the appropriateness of its operations and conditions.
3. Outsourcing of the risk management function should not impair the ability of the competent authority to monitor the adequacy and efficiency of the risk management process and the Company's compliance with all its obligations.

Outsourcing of administrative functions is often a cost-effective method of managing a Company's operations. However, in order to ensure that investor protection is not compromised as a result of an outsourcing arrangement, it is essential that the Company (specifically, its Board of Directors) retains full responsibility for the outsourced function.

To this end, it is necessary to establish clear written mandates that define the role and responsibilities of the outsourced provider. It is also necessary for adequate supervision

and oversight of the outsourcer, to ensure that its personnel, systems and processes are sufficient to manage the risks inherent in the funds. Periodic reviews should be conducted by the Company to ensure that the outsourcer's performance is in line with its mandate (measured, for example, against pre-defined benchmarks or Key Performance Indicators).

Competent authorities and other third parties to the Company should also have access to information held by the outsourced provider upon request. This promotes transparency, and ensures that outsourcing of the risk management function does not impair the ability of others to perform their duties, which could comprise investors' protection.

Accordingly we are supportive of the proposals set out in the Consultation in relation to outsourcing. In addition, we also recommend that, prior to entering into contractual obligations and on a periodic basis during the contractual period, the outsourced provider should conduct due diligence on the Company to ensure that it has the resources necessary to maintain continuity of the business relationship. Frequently changing the outsourced provider is not in investors' best interests due to the operational risks arising from the transfer of data and records. Therefore, it is important for the provider to establish the financial commitment of the Company into the outsourced relationship prior to agreeing contractual terms.

3. Identification and measurement of risks relevant to the UCITS

Box 5: Identification of risks relevant to the UCITS

1. The risk management process should assess and address all risks relevant to the UCITS.
2. Relevant risks should be identified among all possible risks incurred by the UCITS, according to the methods and principles defined by the risk management policy of the Company.

The proposals contained in paragraphs 22-24 in support of Box 5 focus on the identification of all material risks to the UCITS fund, which are a function of the investment objective and strategy pursued by the fund manager. Paragraph 23 proposes that the identification of such risks should be the responsibility of the risk management function, and that the identification process should be continuous to allow for possible changes to market conditions or changes to the fund manager's investment strategy.

The risk identification process could be strengthened further by the establishment of clear and regular communication channels between the portfolio managers and risk management function (as noted in our response to Box 3). Such communication would help to ensure that all sources of risk are properly identified and captured in the risk modelling and measurement systems.

Box 6: Risk measurement techniques

1. The risk management policy of the Company should specify the techniques and tools that are deemed suitable to measure the relevant risk factors attached to the investment strategies and management styles adopted for each UCITS.
2. The risk measurement process should allow adequate assessment of the concentration

and interaction of relevant risks at the portfolio level.

Broadly, the CFA Institute Centre is supportive of CESR's proposals in relation to risk measurement techniques. The risk management policy should set-out the techniques used to measure, and the tools to manage, market risk, credit risk and liquidity risk. As the Consultation notes (paragraph 28), the risk measurement framework should be tailored to the investment strategy of the UCITS fund, such that funds with a higher risk profile necessitate a more sophisticated risk measurement framework than those with much simpler, lower-risk investment strategies.

As Box 6 notes, the risk measurement process should account for the concentration and interaction of risks at the portfolio level. This is particularly important for holdings in structured finance securities, where correlations and default probabilities can have a material impact on the overall risk of the portfolio. We are therefore supportive paragraph 29, which states that *"if UCITS invest in structured products, their multiple risk components should be appropriately identified and managed."*

Furthermore, paragraph 30 addresses situations (particularly relevant for structured products) where quantitative measurement of some risk factors is difficult. It states:

> *"When quantitative measurement of the effects of some risk factors is not possible, or produces unreliable results, Companies may consider integrating and adjusting their figures with elements drawn from a variety of sources, in order to obtain a comprehensive evaluation and appraisal of the risks incurred by the UCITS."*

These provisions ensure that there is an appropriate degree of sophistication in the UCITS' risk measurement framework.

Box 7: Management of model risk concerning the risk measurement framework

1. Companies should deal appropriately with the possible vulnerability of their risk measurement techniques and models (model risk).
2. The risk measurement framework should be subject to continuous assessment and revision, and its techniques, tools and mechanisms should be adequately documented.

The provisions contained in paragraphs 32-38 in support of Box 7 focus on the implementation of robust statistical techniques to estimate and measure risk. We welcome the emphasis on back-testing and stress testing, which, respectively, ensure that model-based forecasts correspond to observed risk measures within a given confidence level, and that the potential impact of unexpected or severe losses are appropriately considered.

Paragraph 33 addresses back-testing:

> *"Back-testing should be carried out separately for every technique used in the risk measurement framework; tests should be run prior to inception (model calibration and internal validation) and, subsequently, on an ongoing basis..."*

Paragraphs 36 and 37 provide guidance on stress testing. Para. 36 states *"Stress tests should cover all quantifiable risks which affect, to a material degree, the value of the UCITS…"* Para. 37 goes further:

> *"Stress tests may reflect subjective scenario hypotheses based on evidence concerning trading and market conditions… during past periods of turmoil. However, such scenarios should not merely mirror historical conditions, but should elaborate on the assumption that similar dynamics could affect the risk factors arising from the UCITS' outstanding exposures."*

These provisions ensure that the statistical modelling techniques employed by Companies are sufficiently robust to capture all estimable risks.

The CFA Institute Centre provides its own guidance on the importance of conducting stress testing in its *Asset Manager Code of Professional Conduct*[4] (the "Code"). Section B of the Code, "Investment Processes and Actions", states that Managers must "Have a reasonable and adequate basis for investment decisions". The guidance to this principle states that:

> *"Managers who implement complex and sophisticated investment strategies should understand the structure and potential vulnerabilities of such strategies… For example, when implementing complex derivative strategies, Managers should understand the various risks and conduct statistical analysis (i.e., stress testing) to determine how the strategy will perform under different conditions."*

In addition to the guidance relating to Box 7, we recommend that Companies' risk management policies set out time-frames for assessment and revision of their risk models, to ensure that the modelling framework remains appropriate relative to the level of risk embedded in the funds. Additionally, as mentioned previously, there should be regular communication between the portfolio managers and the risk management function to ensure that all sources of risk are adequately captured within Companies' risk models.

Box 8: The link between risk measurement and asset valuation

1. Risk measures should be computed having regard to sound and reliable data.
2. The risk management function should provide appropriate support to the valuation process concerning exposures to illiquid assets, structured securities and complex derivatives.

The proposals stemming from Box 8 focus on the quality of data and the valuation process. Where mark-to-market valuations cannot always be applied in valuing securities (such as in distressed markets where transactions cannot be conducted in an orderly fashion), the risk management function can play an important role. Specifically, in such circumstances, mark-to-model valuations may be applied, in which case it is appropriate that the inputs and estimation techniques of the risk measurement models be used to support the valuation process.

---

[4] See *CFA Institute Centre for Financial Market Integrity, "Asset Manager Code of Professional Conduct"*, at http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n4.4008. A revised version of the Code is due to be published in forthcoming months.

Accordingly, we are supportive of paragraphs 39 and 40. Para. 39 states:

> *"…when measuring risks of illiquid assets, risk managers should thoroughly check the robustness of their estimates, testing the data used for the computation against the valuations of actual comparable trades."*

An important additional consideration is the timeliness of actual trades. When using the valuations of actual trades to compare model estimates, and more generally to value portfolio holdings, the relevance of observed valuations is largely dependent on their timeliness. For example, it would be inappropriate to place undue reliance on valuations that relate to last-traded prices that are some weeks or months old, due to market illiquidity. Generally, best practice would require the Company to establish a fair value committee, who should meet periodically to consider the fair value of securities that cannot be priced on a mark-to-market basis. Specifically, the committee should give appropriate consideration to the estimations generated by the models employed by the risk measurement function, such that the valuations ultimately determined by the fair value committee are consistent with model inputs.

The proposals in paragraph 40 are consistent with this point:

> *"Assumptions and models underlying pricing of illiquid, structured financial instruments… or complex derivatives should be consistent with the risk measurement framework used by the Companies. These should be maintained and revised over time accordingly (using back-testing etc.)."*

4. Management of risks relevant to the UCITS

Box 9: Risk management procedures
1. The Board of Directors should define the risk profile of each UCITS managed by the Company. In the initial definition of the risk profile of the UCITS, or in the event of its subsequent revision, the Board of Directors should be advised by the risk management function. 2. The risk management procedures should ensure that the actual level of the risks incurred by the UCITS remain consistent with its risk profile as defined by the Board of Directors.

These proposals are consistent with earlier recommendations contained in the Consultation, namely that there is adequate accountability on the part of the Board of Directors, which we support. In relation to point 1 in Box 9, we would add that, where the Board seeks the advice of the risk management function about revising the definition of the risk profile of the fund, there should also be scope for the portfolio managers to provide input into this process. We would envisage this being achieved through regular communication between the portfolio managers and risk managers (as advocated in previous sections), such that subsequent meetings between the Board and risk management function appropriately incorporate the view of the portfolio managers.

Box 10: Risk limits system

1. The risk management policy of the Company should provide, for each UCITS, a system of limits concerning the measures used to monitor and control the relevant risks.
2. These limits should be approved by the Board of Directors, and be consistent with the risk profile of the UCITS.

The existing provisions of the UCITS Directive already place limits on, amongst other things, asset class concentrations and on exposure to any single security. Paragraph 43 implies as much:

> *"Without prejudice to the limits imposed by the UCITS Directive, a Company should define for each UCITS the limits (the risk limit system) that should be complied with by the UCITS to maintain consistency with the chosen risk profile. The risk limit system should be consistent with the UCITS' investment strategy."*

As the UCITS Directive already contains a number of provisions on investment limits, it would be appropriate for Companies to use these provisions to establish minimum requirements for the risk limit system, which should be tailored to the specific risk profile of the fund.

Paragraph 46 states that *"Records should also be kept of cases in which the limits are exceeded and the action taken."* We recommend that this duty be assigned to a dedicated compliance officer, who would be responsible for capturing and monitoring all breaches, and for subsequently reporting these breaches to regulatory authorities when required.

Box 11: Effectiveness of the risk management process

The risk management policy should define procedures that, in the event of breaches to the risk limit system of the UCITS, result in a prompt correction of the portfolio and provide for the timing of this.

Where breaches of investment limits occur, it is necessary for the portfolio to be rebalanced in a timely fashion so as not to expose investors to a level of risk that may exceed their individual risk tolerance. Paragraph 47 addresses this point.

We also support the proposals in paragraph 48, which focus on mitigating the incidence of breaches:

> *"The risk management process should allow warnings to be generated so that appropriate corrective measures may be taken on a timely basis to prevent beaches. While ongoing warnings should primarily relate to the imminent breach of the predetermined risk limits…, exceptional warnings may result instead from specific assessments addressing possible forecast scenarios that result from a particular concern."*

The implementation of these proposals should ensure that breaches of investment limits are minimised, thus protecting investors from excessive exposure to risk.

We urge caution, however, on the speed with which corrective action should be taken. Consider, for example, the case where the manager needs to re-balance a bond portfolio as a result of adverse credit events. If required to take immediate rebalancing, the

manager could be forced to sell bonds in a distressed market, thus further increasing the loss on the portfolio and putting additional pressure on the risk levels of all other portfolio holdings.

Therefore, rather than requiring immediate rebalancing, it would be most appropriate for managers to take prudent and judicious actions that take due consideration of the breach and the market risk that might come with a swift response.

5. Reporting and monitoring

Box 12: Reporting to the Board of Directors and the Senior Management

1. Companies should implement and maintain efficient internal reporting by the risk management function. The terms, contents and frequency of this reporting should be defined by the risk management policy.
2. The risk management function should report regularly to the Senior Management and, if necessary, to the heads of the different operational departments, highlighting the current level of the risks relevant to the UCITS, and outlining any actual or expected breaches to their limits to ensure prompt and appropriate action is taken.
3. Periodic written reports should be submitted to the Board of Directors, providing an in-depth analysis of the consistency between the actual risks and the risk profile of the UCITS as defined by the Board of Directors.

Each of these proposals ensures that an appropriate level of accountability is placed on the risk management function, through regular formal reporting to Senior Management and to the Board. These proposals also enhance the transparency of the risk management framework, which strengthens the integrity of the decision-making process on the part of the Board. In summary, these measures strengthen the internal governance framework, and therefore support the best interests of investors.

Box 13: Monitoring of the risk management process

1. The Board of Directors and the Supervisory Function, if any, should receive on a periodic basis written reports from the risk management function concerning: (i) the adequacy and effectiveness of the risk management process; (ii) any deficiencies in the process with an indication of proposals for improvement; and (iii) whether the appropriate remedial measures have been taken.
2. The risk management function should review the adequacy and effectiveness of measures taken to address any deficiencies in the risk management process.
3. The risk management process should be subject to appropriate internal or external independent oversight.

The proposals contained in Box 13 reinforce the measures proposed in Box 12, which are welcome. With regards to point 3 in Box 13, independent oversight of the risk management function should fall under the remit of the compliance officer, who is best placed to ensure that the risk management function's procedures, processes and operations are followed in accordance with the terms of the risk management policy.

17th October 2008.