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Is the Luxembourg UCITS Regime a Sign of What is to Come for US Mutual Funds?

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On December 11, 2014, the Chair of the Securities and Exchange Commission (the SEC), Ms. Mary Jo White, spoke at the New York Times DealBook Opportunities for Tomorrow Conference in New York City.[1]

The topic of Ms. White's speech was "Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry." Ms. White stated that at:

> the most basic level, the staff is considering whether broad risk management programs should be required for mutual funds and ETFs to address the risks related to their liquidity and derivatives use, as well as measures to ensure the Commission's comprehensive oversight of those programs.

In addition, Ms. White stated that:

> my main focus today is on portfolio composition risks and operational risks … [t]he Commission has regularly sought to evaluate and enhance its regulations to address [these] risks.[2]

The concepts and principles mentioned by Ms. White regarding the management of portfolio composition and operational risks are reminiscent of similar concepts and principles that have been used by Luxembourg's Commission de Surveillance du Secteur Financier (the CSSF) "which supervises the professionals and products of the Luxembourg financial sector."[3] The CSSF regulates Undertakings for Collective Investment in Transferable Securities (UCITS funds), publicly registered investment companies which are, generally, similar to US mutual funds. In regulating UCITS funds, the CSSF requires that the UCITS funds adopt a risk management model. Could this model used by the CSSF provide hints regarding the direction that the SEC may take in creating and imposing a risk management process for investment companies?

Background

There is no consistent definition or categorization of "risk." In some ways, not having a "consistent view" on risk is a risk. For this article, and for purposes of evaluating a regulatory process, we will consider risk as the probability that some action or inaction will lead to a negative effect on the investment company. While this definition is sufficient for our purposes, we are cautioned that:

> [t]he term "risk" is usually associated with downside or bad outcomes, but when trying

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> to understand financial risk, limiting the analysis to just the downside would be a mistake. Managing financial risk is as much about exploiting opportunities for gain as it is about avoiding downside.[4]

Risk can generally be divided into four major categories: market risk, credit risk, liquidity risk, and operational risk.[5] The first three categories of market risk, credit risk, and liquidity risk are within what Ms. White refers to as "portfolio composition risk." Contained within the category of operational risk are the sub-categories of operations, legal and compliance.

The oversight of risk of a US open-end, investment company regulated under the Investment Company Act of 1940 (mutual fund) is the responsibility of the mutual fund's board of directors.[6] However, the formal oversight of this responsibility is nascent for many funds. For example, Item 17(b) of Form N-1A requires that a mutual fund "disclose the extent of the board's role in the risk oversight of the Fund, such as how the board administers its oversight function and the effect that this has on the board's leadership structure." However, there is no formal regulatory requirement that risk processes be documented unlike how an investment company is required to adopt a compliance manual[7] or appoint a chief compliance officer.[8]

The oversight of risk of a Luxembourg UCITS fund is much more formalized than a US mutual fund.[9] Like a mutual fund, risk is "ultimately the responsibility" of the UCITS fund's board of directors.[10] However, unlike a mutual fund, a UCITS fund is required to have a formalized set of risk management processes (the RMP) that is approved by the board. The RMP is a separate and distinct document from the compliance manual. The purpose of the RMP is to "ensure compliance with the UCITS [fund's] risk limit system including statutory limits, concerning global exposure and counterparty risk."[11]

In practice, the RMP is not an "off the shelf" document. It is specifically tailored to the UCITS fund identifying its key risks; describing, with some specificity, how such risks are addressed; and identifying internal and external stakeholders who are responsible for managing those risks. For example, "UCITS funds can offer leverage (in UCITS also called Global Exposure). Direct short selling is not permitted nor is borrowing for investment purposes. However, leverage can be generated through the use of derivatives or through repos."[12] The RMP specifically addresses how the UCITS fund will manage the "portfolio composition risk" or "Global Exposure" and whether it will use the "value at risk" (VaR) or the commitment approach.[13] In addition to the portfolio composition risks, an RMP will also include procedures to mitigate operational risks such as infrastructure, systems, and conflicts of interest.

The RMP is filed with, and approved by, the CSSF. It is required to be updated and filed with the CSSF at least annually and whenever any material changes are made.

In addition, the UCITS fund must appoint at least two Conducting Officers,[14] one of whom will be responsible for overseeing its risk management function. This "Chief Risk Officer" is responsible for: ensuring that the UCITS fund's risks are reviewed and monitored; resolving any issues; and reporting back to the board of directors. The CSSF requires that the oversight of the risk management process is not performed by the same Conducting Officer that oversees the investment process. This is a clear departure of how portfolio composition risk is generally managed in the US where the portfolio managers are responsible for performance and portfolio composition risk management.

Conclusion

The UCITS regime has a more structured and defined format regarding the approach to and oversight of risk management of investment companies. In Ms. White's speech, she states that:

> A more comprehensive approach is required to address the risks associated with the

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> increasingly diverse nature of fund holdings and the use of derivatives.

And that:

> we must take steps to ensure that registered funds enhance their fund-level controls so that they are able to identify and address risks related to the composition of modern portfolios, whether those spring from the overall financial profile of a fund, such as its liquidity levels, or the nature of specific instruments, such as derivatives.

It is clear from Ms. White's statements that the SEC is contemplating requiring a broad based risk management process through regulation. While the size and scope of the process is still unknown, we can infer that the risk management process the SEC will develop will be more comprehensive and rigorous for investment companies. An example of one such regime already exists in Luxembourg, which requires UCITS funds to adopt an RMP and appoint a Risk Management Conducting Officer. Perhaps, requiring that mutual funds adopt formal risk management procedures and appoint a "chief risk officer" is not that far off.

In addition, Ms. White highlighted the management of portfolio composition risks. However, what was not specifically addressed was where does the SEC view as the appropriate place for managing portfolio composition risk… with the portfolio managers or a party outside of the portfolio management staff?

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NOTES

1 *See http://www.sec.gov/News/Speech/Detail/Speech/1370543677722.*

2 Ms. White clarified that "[b]y 'portfolio composition risk,' I mean the risk related to the mix of a fund's investments and the impact that mix, including the interaction of particular financial instruments, can have on a fund."

3 *http://www.cssf.lu/en/about-the-cssf/about-the-cssf/.*

4 Thomas S. Coleman, *A Practical Guide to Risk Management*, Research Foundation of CFA Institute (July 8, 2011).

5 "Risk Taking: A Corporate Governance Perspective," *International Finance Corporation*, June 2012.

6 Fund Board Oversight of Risk Management, Independent Directors Council and the Investment Company Institute (September 2011).

7 Pursuant to Rule 38a-1 under the Investment Company Act of 1940, an investment company is required to adopt a set of "written policies and procedures reasonably designed to prevent violation of the Federal [s]ecurities [l]aws by [a mutual] fund, including policies and procedures that provide for the oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent of the [mutual] fund" (the compliance manual).

8 In addition, Rule 38a-1 requires a fund to "[d]esignate one individual responsible for administering the fund's [compliance manual]."

9 There are key distinctions in the structure between a mutual fund and a UCITS fund. Key among those distinctions is the appointment of a management company "ManCo" to oversee the UCITS fund. The conducting officers, risk management processes, and compliance manual are then at the level of the ManCo, with the ManCo being supervised by the UCITS fund's board of directors. For purposes of this article, some of these distinctions are "glossed over" in order to facilitate a cogent discussion regarding the differences in risk management.

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[10] *Association of the Luxembourg Fund Industry - Risk Management Guidelines* (Revised version March 2012).

[11] *Id.*, referencing Regulation 10-4 Article 13 of the CSSF.

[12] Carne Group, *UCITS Guide for Alternative Fund Managers*, available at *http://www.carnegroup.com/wp-content/uploads/2012/06/Carne-UCITS-Guide-for-Alternative-Fund-Managers.pdf.*

[13] "Commitment Approach: A UCITS that does not extensively use derivatives nor uses complex derivatives can opt to measure leverage using the "commitment approach." This approach looks at the market value of the asset underlying the derivative (which can be delta adjusted for options) and takes a simple aggregate of the absolute values of the underlying exposures (or notional values). Adjustments can be made for netting arrangements, and contracts that are used for hedging purposes (risk reducing) do not need to be included in the calculation. Leverage up to a gross market exposure of 200 percent of NAV is permitted under the commitment approach.

Value at Risk: A UCITS that extensively uses derivatives and/or uses complex derivatives may alternatively choose to measure leverage based on a Value at Risk (VaR) measure. The regulations permit two types of VaR measure: absolute VaR and relative VaR. The absolute VaR limit depends on the risk profile of a fund but the maximum absolute VaR is 20 percent over a 20 day holding period based on a confidence interval of 99 percent. The relative VaR limit is twice the VaR of a derivative free benchmark. There are some further conditions on the use of VaR as a tool to measure leverage such as having in place an appropriate stress testing and back testing regime." (See note 10).

[14] A Conducting Officer or *dirigeant* is a "day-to-day manager" that reports directly to the board. The rough US equivalent would be a co-CEO who has a distinct area of responsibility.

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