The Practical Considerations of implementing Risk Management functions; a Director's and AIFM's perspective.

1. Who is responsible?

As a director of a Fund, or of any legal entity for that matter, you will have joint responsibility for the success of the entity, including pursuing its defined objectives and managing risks that it will encounter.

Now that the Alternative Investment Fund Managers Directive is effective, it has introduced an additional party (the AIFM) who has to pursue the objectives of the Alternative Investment Fund (or AIF) and to ensure that risks are properly managed.

The overlapping responsibilities between the Board of the AIF and the AIFM has led to many hours of fevered discussion, with many different divisions of labour and escalation paths being established in different organisations. This debate does not necessarily have 'right' and 'wrong' answers, as the needs of different AIFs and the capabilities of different AIFMs will demand different solutions. I expect that we will still be debating elements of this when AIFMD II is negotiated in the post-2017 review period.

It's important to clarify the decision-making process, in particular for the Board of the AIF, in order to anchor the substance of the decision-taking in the country of domicile of the AIF. This is particularly important where the AIFM is providing a cross-border service, as local tax administration and regulators will want to know who and where the final decision-making entity is.

2. Where did these requirements come from?

The idea of requiring well-documented risk management policies is not an AIFMD invention. Following the near collapse of the Long-Term Capital Management Hedge Fund (LCTM) in 1997/98, and the subsequent $3bn bailout supervised by the US Federal Reserve, in April 1999 the President's Working Group on Financial Markets (the "PWG"), comprised of the Secretary of the U.S. Department of the Treasury and the respective chairs of the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission and the Commodity Futures Trading Commission, published its report entitled "*Hedge Funds, Leverage and the Lessons of Long-Term Capital Management".* In one section, the report recommended that

> *"A group of hedge funds should draft and publish a set of sound practices for their risk management and internal controls. Such a study should discuss market risk measurement and management, liquidity risk management, identification of concentrations, stress testing, collateral management, valuation of positions and collateral, segregation of duties and internal controls, and the assessment of capital needs from the perspective of hedge funds. In addition, the study should consider how individual hedge funds could assess their performance against the sound practices for investors and counterparties." (PWG Report, at p. 37)*

In February 2000, a group of six hedge funds published "Sound Practices for

Hedge Fund Managers", in response to that call. Since then, the Managed Funds Association (Washington), the Alternative Investment Management Association (London) and the Hedge Fund Standards Board (London) have published various frequent updates and extensions to guidance for Hedge Fund Managers, while industry bodies for other investment sectors have followed suit (e.g. EVCA for Private Equity, INREV for Real Estate).

"Sound Practices for Hedge Fund Managers" February 2000

What is striking is the consistency of the recommendations. If you consider the contents of the 2000 report (see box), all of the main elements are topics of concern under AIFMD. What has changed is that self-regulatory Best Practices have now been implemented as mandatory requirements of European Law.

3. What is required under AIFMD?

One of the key documents to be included in an AIFM application for authorisation is the Risk Management Policy, which also requires details of the risk management processes. This document lays out the obligations of the Management Company for risk management, defines the risk governance structure, how responsibilities and resources will be allocated, and identifies the different categories of risk that will need to be identified, measured, mitigated, monitored and managed.

Key AIFM Regulation Articles on Risk Management

Article 38: Risk Management Systems
Article 39: Permanent risk management function
Article 40: Risk Management Policy
Article 41: Assessment, monitoring and review of the risk management systems
Article 42: Functional and hierarchical separation of the risk management function
Article 43: Safeguards against conflicts of interests
Article 44: Risk Limits
Article 45: Risk measurement and management

While some of these elements will be consistent across different fund types and investment strategies, some require deep knowledge of the specific fund and investment type to develop an effective policy that enhances the investment process while ensuring that key risks are not overlooked. In liquid markets, market liquidity, trading patterns and price volatility are key risk issues that have to be tracked and possibly responded to on an intra-day basis. In real estate markets, risk issues relate more frequently to tenants, obsolescence, mortgage financing and operational risks, and the response cycle is more likely to be monthly or quarterly.

4. Who will do this work?

A further significant challenge is identifying members of the organisation who can credibly take responsibility for risk management of different flavours, as the AIFM needs to accord equivalent status (and therefore seniority) to both portfolio management and risk management. When firms do not have the right skillsets or experience on their staff, an option may be to engage an external risk manager on a part-time basis, or even outsource the entire risk management function to a third party.

Potential Risk Governance responsibilities

Board of AIF
Board of AIFM
Senior Management of AIFM
Conducting officer for Risk Management
Permanent risk management function
Risk data collection & calculation team
Local Management
Asset Managers
Asset Servicers

Where organisations choose to distribute different functions to specialist business units in their group, or hire external parties, the role of the risk manager in overseeing these distributed processes on behalf of the AIFM and the Board of the AIF becomes even more important.

5. Developing a relevant risk approach

Risk management for the AIFM will includes risk identification, risk measurement, risk mitigation and risk reporting. Its objective is to mitigate the potentially negative effects these risks can have on the financial result and capital of the AIFs under management, but also to reflect potential negative outcomes for its service-partners and clients. Risks which are or may be material to the AIFs are identified by the Risk Manager in *ex-ante* due diligence before starting to trade in any new investment market or instrument, and then on an on-going basis, via *ex-post* reviews on actual trading, with the frequency depending on market, legal and operational conditions, and considering the complexity of the underlying investments and ownership structures.

ALFI Guidelines for Risk Management under AIFMD – Risk Matrix

Assets concerned
Description of measures/ controls
Quantitative/ qualitative approach
Approach to limitation of risks
Frequency of measurement
Reporting/ Escalation
Owner/ Controller

The due diligence process is frequently used to construct a Risk Matrix, identifying the sources of risk, measures used to manage them and the responsible parties. This is a useful tool that is used by the Risk Manager on an on-going basis and should be reviewed at least annually with Senior Management.

6. Conclusions

Risk Management is not a new idea, and the best Investment Managers have always placed risk at the centre of their process, managing the Fund to achieve the investment objectives within a well-understood risk envelope. Under the

AIFMD, the Risk Management Function has been elevated to equivalent status to Portfolio Management, and AIFM's need to spend sufficient energy, resources and attention on this area to implement a function that adds to the sum of the Fund Management business, rather than simply being a box-ticking exercise.