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Risk-based approaches to global compliance and regulation

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Chair

Laurence Cranch *EVP and General Counsel, Alliance Capital Management LP, New York*

Speakers

Robert Plaze *Associate Director, Regulatory Policy & Investment Adviser Regulation US Securities & Exchange Commission (SEC), Washington DC*

Adrian Tyerman *International Compliance Officer, Janus International Ltd, London*

Daniel Waters *Director, Retail policy, UK Financial Services Authority (FSA), London*

Francisco Silva *Chief of Division of Research and International Relations, Superintendencia de Valores y Seguros (SVS) (Chile), Santiago*

Laurence Cranch initiated an interesting exchange of views between the regulators from the US, the UK and Chile on the importance of risk-based approaches to regulation.

Robert Plaze from the US SEC stated that the SEC is initiating several changes intended to strengthen its mutual fund exam programme but faces challenges overseeing the fund industry. The SEC is looking at ways to update and improve its inspection programme to reflect the realities of today's investment management industry. In the wake of fund abuses, the SEC has revised its past approach of primarily conducting routine examinations of all funds on a regular schedule. It concluded that these exams were not the best tool for identifying emerging problems, since funds were not selected for examination based on risk. It has recognised that a one inspection every five years, 'one size fits all'

approach to conducting inspections is no longer appropriate. The SEC approach to evaluating the risk management and internal control systems used by funds and advisers is more structured than in the past, and its goal is to focus its exams on areas of real risk to investors. To quickly identify problems, the SEC is shifting resources away from routine exams to targeted exams that focus on specific risks. It will conduct routine exams on a regular schedule but only of funds deemed high risk. The SEC is also forming teams to monitor some of the largest groups of advisers and funds. The SEC also believes it should rely on firms' own internal controls to a greater extent where those controls are demonstrably robust. Under this new approach, the first steps in an inspection will involve discussions with operating managers and compliance staff to obtain a complete understanding of the firm's control procedures in what the SEC believes are the most critical or strategic areas. These areas reflect the activities of advisers and funds that were the basis for the great majority of enforcement actions the SEC has brought against advisers over the past ten years.

Dan Waters from the UK FSA, before describing the 'ARROW' framework of risk-based supervision performed by the FSA, referred to the implications and benefits of the risk-based approach. As to benefits for the regulator he identified several, observing that such an approach:

- optimises the use of resources;
- makes the FSA focus on risks to its objectives and on relevant outcomes;

- provides a sound, consistent basis for the FSA's approach and actions;
- provides a measure of success;
- facilitates a pro-active approach; and
- embeds an 'early warning' methodology.

The benefits for regulated firms are that:

- firms see a direct result of good behaviour and control of their risks;
- supervision is less intensive – a regulatory 'peace dividend';
- firms receive a transparent explanation for the actions taken by the FSA;
- actions taken by the FSA should be proportionate and consistent; and
- a proactive approach to managing risks is generally preferable.

As to the ARROW framework itself, Dan Waters explained how the FSA measures risk. It considers that an issue becomes a priority to the FSA if the 'score' is sufficiently high. The score is obtained by combining, on the one hand, factors concerning the *impact* if the problem occurs (examples of such factors being the size of the firm, the number of retail consumers and the perceived importance) and, on the other, the factors concerning the *probability* of the problem occurring (examples of such factors being business risk, control measures and consumer risk). In assessing *impact* in the case of asset managers the FSA is currently using metrics based on AUMs. New, more complicated impact metrics will be used in the future by the FSA, including consumer impact (eg number of contracts), market impact and a sector weighting. Firms with an impact score of medium-low or above will be subject to periodic full assessments. While these are relatively few in number, they represent the majority of the UK financial services market. If the firm is large enough to warrant a full assessment, the next stage in the process is to make an initial assessment of *probability*. Once the assessment plan has been agreed, an on-site visit is conducted to investigate the potential issues identified and fill remaining information gaps. If the FSA judges that the firm's senior management is effective, the FSA would not normally perform detailed testing (eg reviews of documentation, etc), although the FSA may resort to this approach where it does not feel that it can rely on the firm's high-level controls. Finally, Dan Waters went on to explain the aims of the FSA's Improvement Project. Among such aims are to embed the FSA's risk-based approach more fully into every aspect of its activities, facilitated by a targeted cultural change campaign, and to improve communication with firms on the FSA's assessment of them and involve them more fully in the process.

Francisco Silva of the SVS of Chile expressed the opinion that this regulator had identified a clear need for a re-engineering of its supervisory approach (meaning a move to a risk-based approach to supervision) of local mutual funds, for various reasons.

One such reason was the optimisation of limited supervisory resources in the context of rapid market growth and sophistication (25 per cent annual growth rate over the past three years of AUMs to US\$15,000,000,000 and number of shareholders to 700,000). Another reason was to reinforce market confidence. Likewise, there was a perception that it was reasonable to consider the differences in quality of internal controls by fund management companies and that it was more effective to move from a supervision of causes rather than consequences.

To go about implementing this new approach, the SVS first identified five pillars of supervision of mutual funds: (i) investment and trading; (ii) valuation; (iii) custody; (iv) integrity; and (v) resolution of conflicts of interest. The next step has been to identify the risk factors, which are the variables that influence the risk that a regulatory pillar be negatively affected. The election of risk factors is by far the most important element of this new model. It guides analysts to the observation of the key issues affecting the regulatory risk of an entity. If the regulator looks at the wrong variables, the result will be misleading. Once the risk factors have been identified, the SVS will start making an analysis of the so called net risk that will determine the frequency of inspections, variables to focus on and areas to improve within each asset management firm. In determining net risk the SVS will look at probability and impact as factors and internal controls as a mitigator.

Adrian Tyerman of Janus provided the view of a compliance officer in relation to risk-based compliance monitoring. He began his presentation by first defining risk-based monitoring as establishing and implementing risk-oriented systems, monitoring internal controls and processes and evaluating whether a company achieves its objectives of compliance with regulation. The aim of risk-based compliance monitoring is to set the frequency of monitoring and focus monitoring resources around risk, so that the higher the risk the more frequent the monitoring. Another aim is to reduce the frequency of monitoring by having better information on the operation of controls. Mr Tyerman referred to the risk equation where risk equals probability times impact. Based on this reality, Mr Tyerman presented a risk diagram which starts with the analysis of the risk environment, identifies the risk groups and continues with the risk and control assessment and key risk and control indicators, and finishes with the action plan, measurement, monitoring and reporting.

Mr Tyerman also outlined the risk-based compliance model and set out the necessary components of effective risk management: (i) issue a risk policy statement; (ii) raise risk awareness among management; (iii) provide a foundation for the understanding of operational risk to all staff; and (iv) risk reporting.

Mr Tyerman continued his presentation by giving a typical structure of policies and procedures in which compliance is subject to a risk-based approach.

Evolving principles of fund governance

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Moderator

Rebecca Cowdery *Partner, Borden Ladner Gervais LLP, Toronto*

Speakers

Sander M Bieber *Partner, Dechert LLP, Washington DC*

Tara Doyle *Partner, Matheson Ormsby Prentice, Dublin*

Cyrille Stévant *Autorité des Marchés Financiers, Paris*

Rebecca Cowdery gave the Canadian perspective on developments in fund governance. She stated that, at present, Canadian regulation does not require any form of independent oversight over how a mutual fund is managed. Conflicts of interest are handled through strict prohibitions and restrictions on self-dealing (although regulatory exemptions and relief can be received).

Over the past ten years, Canadian industry participants and regulators alike have focused on the need for enhanced fund governance through some form of mandated independent oversight as well as through a focus on regulating the mutual fund manager either in addition to or in substitution for, the product (the mutual fund). The goal has been to reinforce the fund manager's fiduciary responsibilities to investors and to enhance investor protection from potential improper handling of conflicts of interest by a fund manager.

Regulatory initiatives resulted in a concept paper from the Canadian Securities Administrators 'Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers', released for comment in March 2002. Continued work in the area of fund governance resulted in the publication of 'National Instrument 81-107' Independent Review Committee for Investment Funds in January 2004, along with its second publication for comment in May 2005. NI 81-107 is expected to become law later in 2006 or early 2007. Under the proposed NI 81-107 a manager of an investment fund must establish an independent review committee (IRC) within six months of NI 81-107 coming into force. Implementation can be expected to be 'bumpy', particularly in light of the relatively clean compliance record of the Canadian investment management industry and the perception that nothing more is needed in the way of new regulation. Smaller fund managers, who are not part of financial conglomerates (and therefore have no related party dealings), can be expected to be particularly bemused about the need for enhanced fund governance in the

form of NI 81-107 as it applies to their management of their funds.

Sander Bieber presented the evolution of fund governance in the United States. He referred to the pre-reform 1940 Act Governance Standards in relation to board responsibilities, independent director responsibilities and the role of fund shareholders. After outlining the 1999 ICI fund governance 'Best Practices' and the 2001 fund governance standards he went on to talk about how Sarbanes-Oxley had increased the role of the fund audit committee. Mr Bieber then focused on the 2004 Fund Governance Standards Reform, which is aimed at strengthening independent directors' power (effective 16 January 2006).

Under this reform 75 per cent of the board must be independent and the Chair of the Board must be independent. This latter requirement has received severe criticism from the US fund industry. The reform further expands into board conduct. In this sense the fund board must conduct an annual self-assessment and must consider the effectiveness of its committee structure and the number of fund boards on which each director serves. Likewise, independent director meetings must be held quarterly and no interested directors may be present. In addition, independent directors must have authority to retain employees and experts, in order to assist the independent directors in dealing with matters beyond their expertise. Mr Bieber further outlined the long list of exemptive rules that are conditioned on fund governance standards.

Greater transparency was also introduced by this 2004 reform in relation to advisory contract approval. Boards must disclose the material factors and conclusions that formed the basis for approval and renewal of advisory contracts. Likewise, the specific factors considered in selection of the adviser and approval of the advisory fee, including the use of comparative data, must be disclosed in periodic reports to shareholders and proxy statements soliciting approval of the agreement.

Mr Bieber considered that the current status of US fund governance was the existence of an independent board with substantial oversight responsibilities, greater transparency in conduct and actions and a high degree of accountability to shareholders, regulators and the investing public.

Tara Doyle talked about the evolution of fund governance in Europe and Ireland. The topics she covered were the Irish approach to corporate

governance of management companies and investment companies; UCITS III – the Management Company Directive; and possible future developments. In outlining the Irish approach, Tara Doyle referred to the following:

- Laws generally applicable to all Irish companies, in particular the Companies Acts 1963 to 2005 (Companies (Auditing and Accounting) Act 2003 (CAA 2003)) and the common law rules and equity. Under such laws, conflicts of interest are permissible provided they are disclosed.
- Rules specifically applicable to management companies and investment companies, in particular the Central Bank and Financial Services Authority of Ireland Act 2004 (financial services equivalent of the CAA 2003) and the NU Series of Notices issued by the Irish Financial Services Regulatory Authority (IFSRA), whereby a minimum of two directors must be Irish resident; prior approval of IFSRA is required for the appointment of directors; and common directorships with trustee companies are not allowed.
- Rules specifically applicable to listed investment funds, whereby at least two directors must be independent.
- Rules specifically applicable to UCITS management companies and investment companies, whereby a two-man management is required as well as adequate internal control mechanisms. Likewise, a code of conduct must be adopted.

As to future developments, Tara Doyle referred to the implementation of the Central Bank and Financial Services Authority of Ireland Act 2004, the review of UCITS III in practice, the Markets in Financial Instruments Directive (2004/39/EEC) and the European Commission Action Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union.

Cyrille Stévant provided the French perspective on asset management regulation. He provided an overview of international regulatory principles for fund governance. In this respect Mr Stévant referred to the international background whereby current trends (outsourcing of operational functions and the move towards open-architecture) and recent events have created strong incentives for regulators to address the collective investment schemes (CIS) governance issue. Mr Stévant went on to analyse the document entitled 'Examination of Governance for CIS' which under the IOSCO SC5 Fund Governance mandate was published on 1 February 2005 for consultation. In this document, CIS governance is defined as 'a framework for the organisation and operation of CIS that seeks to ensure that CISs are organised and operated efficiently and exclusively in the interests of CIS investors and not in the interests of CIS insiders'. Conflicts of interest are the key issue. The extent of feedback to the public consultation and the hearing organised by SC5 have demonstrated a strong interest for the SC5 work.

As to the next steps for IOSCO principles, Mr Stévant referred to the work to be released in the short term on the Independent Oversight Entity. This work will refer to, among other aspects, the main functions to be performed by independent entities, which could include approving the code of ethics of the asset management company and approving the written compliance procedures and policies of the CIS and each service provider.