

# How to better mitigate risks in the investment funds area in the light of the Madoff fraud and of the lessons of the financial crisis?



## I. Risk management has become a priority for fund managers and regulators with the financial crisis:

- The financial crisis, with the liquidity issues that some money market funds in particular faced last year and with the Lehman default, has put more emphasis on the liquidity and counterparty risks that asset managers have to mitigate, in addition to operational and market risks<sup>1</sup>. Concerns about the viability of financial institutions in general have also stressed the importance of better monitoring the overall risk of management companies taking into account the different risk components mentioned above.
- The European ramifications of the Madoff fraud have in addition put forward the potential risks asset managers, depositaries and investors may face with delegation arrangements of investment management and custody functions and the need to review the safeguards provided to investors in case of fraud or bankruptcy of service providers, particularly outside Europe. The recent decision of justice in France obliging two depositaries to return clients' assets put in sub-custody with Lehman Brothers further illustrates these types of risks.
- In addition to these risks asset managers have to face distribution risks, which will not be covered in this paper and which require further analysis<sup>2</sup>.

## 2. Many proposals for improvements have been made by the EU Authorities and the industry since the crisis broke out, to better mitigate risks in the investment funds areas:

The UCITS Directive already comprises requirements to mitigate portfolio and liquidity risks for UCITS funds.

## Several improvements to the regulatory and supervisory framework of UCITS and non-UCITS funds have been proposed following the financial crisis:

- The proposals made in the de Larosière report should help to improve macro-prudential supervision of financial markets in general through the EU Systemic Risk Council and greater power given to the Level 3 Committees which will be transformed into Authorities with binding powers.
- Level 2 risk management measures are being defined in the context of the implementation of the management company passport in the UCITS IV package and a consultation was recently conducted by CESR on risk measurement methods and risk models.
- The AIFM proposal (Alternative Investment Fund Manager) currently under review for Alternative Investment Funds (AIF ie all non-UCITS funds) proposes specific solutions to better monitor the systemic risks represented by some fund managers and to improve at an EU level the regulatory oversight of these funds, which are regulated at present only at the domestic level.
- The communication published in July 2009 by the Commission on the way to increase safety in OTC derivatives markets should contribute to mitigating counterparty risks of investment funds investing in derivatives. Further product standardisation is encouraged as well as a wider use of CCPs and trading on organized venues.
- The creation of a regulatory framework for credit rating agencies will give further guidelines for evaluating the risks and liquidity of investment products.
- The projected Directive on EU securities law should propose rules for increasing certainty of legal ownership of securities holdings in particular.

## Improvements of market practices are also underway:

- Risk management principles published by CESR in February 2009 define guidelines for improving the risk management organization

<sup>1</sup> Operational risks are related to order executions and portfolio valuations. Market risks are related to the fluctuations of assets comprising the portfolio. Country risks specific to the country in which assets are located should also be considered. Liquidity and counterparty risks have been amplified in particular by the increasing use of derivatives and leverage more widely permitted by UCITS III

<sup>2</sup> UCITS IV adopted in 2008 should improve investor information with the KID (Key Investor Document). MIFID and the Prospectus Directive give additional guidelines to limit misleading risks at the distribution level. Recommendations

have also been made by the Commission earlier this year to improve product information and distribution processes for comparable investment products (ie structured products, etc...). Further analysis is required on the adequacy of fund offerings to investor needs, on the information given to investors, on the ways to foster a long term investment perspective, etc... These topics are well covered for example in the study conducted by the Asset Management Think-tank "Building long term savings in Europe" Jan 2009

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and processes of UCITS funds, completing the measures of the UCITS Directive. These principles could potentially be extended to other types of funds. Recommendations are made in particular to set up an independent risk management function. Strict enforcement should be required to make sure these measures are widely implemented by asset managers, with adequate know how and tools.

- IOSCO has recently published recommendations for hedge funds concerning liquidity risk management and due diligence processes
- Recommendations recently published by EFAMA and IMMFA propose a common definition of money market funds and a stricter codification of the assets in which they can invest with a view to avoid in the future the liquidity risks experienced by these funds.

### 3. Clarifications are still required in the way asset safekeeping activities should be performed to limit risks represented by sub-custody arrangements in particular

Many players believe that the dispositions relative to depositary activities in the UCITS Directive need to be reviewed, to take into account the increasing complexity and variety of assets safekept and of countries covered and the evolutions in custody and delegation arrangements. Many also consider that depositary rules for UCITS funds and AIFs<sup>3</sup> need to be defined in a coherent way as far as possible and building on existing UCITS rules to avoid regulatory arbitrage and to facilitate their enforcement by companies managing both types of funds. Therefore the improvements suggested below should also be considered for AIFs.

The consultation currently undertaken by the Commission concerning depositary responsibilities for UCITS funds should be a starting point for further proposals in this field.

- **The contents of the asset safekeeping function needs to be defined in a more precise way in the UCITS Directive** to foster more coherent rules across the EU and to reflect established standards and best practices used in the market. At present this function is defined in different ways in domestic legislations due to the heterogeneous transposition of the Directive. It is described as an "asset keeping" function in some countries, where depositaries are required to keep a custody system on which the assets are

recorded, while in others it is considered as "position or record keeping", closer to control or oversight of the assets, to guarantee their ownership and existence.

- **The responsibilities of the different players along the value chain<sup>4</sup> need to be defined more precisely and accounted for, particularly in case of delegation of the custody of assets**, to ensure a better balance of responsibilities and avoid uncertainty in case of default. This is particularly the case for the areas where the responsibilities of depositaries and asset managers overlap and where the obligations of both parties should be clearly defined<sup>5</sup>. Depositaries are indeed dependent in some cases on the geographical investment decisions made by asset managers (e.g. international funds may invest in exotic or risky countries where only a limited number of sub-custodians operate). Other cases may encompass assets of target funds within fund of funds which have their own depositary and in some cases their own registrar (TA)<sup>6</sup> etc... Responsibilities may also need to be modulated according to the financial instruments concerned. Differences between transferable securities - where depositaries ensure the custody of assets – and derivatives – where depositaries play a record keeping activity and where prime brokers often play an important part, which is not mentioned in the Directive, should be taken into account for example. Depositaries should not be liable for cash that the asset manager has decided to deposit in other banks and which is not in its books.
- Liabilities also need to be clarified, taking into account the prudential mechanisms available to mitigate them and their potential economic impacts for the different stakeholders.

The first decision to be made is whether investors and distributors should bear any financial risks related to the safekeeping arrangements of fund assets. This question remains open, particularly for professional investors and for risks inherent to investment decisions made by investors<sup>7</sup>, but would require finding solutions for investors to be adequately informed of the possible risks they might bear<sup>8</sup>.

Regarding the liabilities of industry players, some asset managers and political decision makers are favourable to a tightening of depositary liabilities, in line with the proposal recently made by the Commission for AIFM<sup>9</sup>, which is close to an obligation of result. Other players stress that first there is a need for further clarification and harmonisation

<sup>3</sup> In the AIFM proposal

<sup>4</sup> Asset managers, depositaries, prime brokers, sub-custodians, etc...

<sup>5</sup> Including eg due diligence obligations or obligations to provide adequate information on the assets safekept for example

<sup>6</sup> In countries where fund shares are not registered in the CSD

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of the role and responsibilities of depositaries and asset managers before deciding on the liabilities. Depositaries point out that if they are constrained to systematically cover all losses in case of default, this would increase their costs significantly and strongly impact their economics<sup>10</sup>, leading to exits from some markets or even creating potential systemic risks in some extreme cases<sup>11</sup>. They add, as mentioned above, that decisions and responsibilities regarding e.g. the choice of custody providers are sometimes shared with other players.

We therefore believe that alternative solutions need to be considered.

One alternative option could be to split liabilities between depositaries and asset managers or any other players involved, depending on their respective responsibilities. This could be difficult if it meant increasing quite significantly the own funds of asset managers. Another option worth considering could be to set up a guarantee fund at market level, financed by the different players involved in asset safekeeping. This would have the advantage of mutualising costs across the industry, provided strict rules can be enforced for financing, governance, oversight, etc... but could lead to higher fees passed on to investors than in a system allocating risk across market stakeholders according to some observers.

- **Defining more precise rules for conducting due diligence processes of sub-custody providers, should also be considered by EU authorities and the market** to ensure that a common baseline is established throughout the EU. Criteria for selecting sub-custodians could be clarified for example based on current good industry practice as well as standards for monitoring performance on an on-going basis against the selection criteria. Some depositaries consider that the respective responsibilities of depositaries and asset managers should also be identified in this field<sup>12</sup>.

## 4. Additional measures would be worthwhile considering in the asset management area to improve the mitigation of liquidity and counterparty risks:

### 4.1. Measures to mitigate liquidity risks should be extended beyond money market funds particularly for UCITS funds:

UCITS funds have to be redeemable at least twice a month when

the NAV (Net Asset Value) is calculated. This can create liquidity or valuation problems for funds in some circumstances, for example if the underlying assets turn out to be illiquid or difficult to trade.

Different options should be examined to better mitigate the potential liquidity risks of UCITS funds:

**Fund rules could be reviewed:** the pros and cons in terms of costs, performance and operational feasibility of different approaches should be further evaluated:

- Reviewing redemption rules to better take into account the liquidity of underlying assets and the investment horizon of different fund categories, particularly those which are designed for medium to long term holding periods and do not require quasi immediate redeemability.
- Authorizing side-pockets for illiquid assets, as for hedge funds, to separate illiquid assets from more liquid investments<sup>13</sup>.
- Strengthening liquidity obligations on the portfolio side imposing funds to hold a minimum % of assets in cash or putting in place a compulsory liquidity scheme at market level.
- Allowing redemptions to be suspended for a limited period if a specific plan is put in place to manage the illiquid assets.

**Extending the measures proposed for money market funds to other fund categories** with a reviewed classification of funds and codification of the assets in which they can invest could also be considered at EU level (e.g. through an industry code of conduct or recommendations issued by CESR) to ensure greater coherence within the industry and with the classifications used by regulators and performance measurement agencies. The liquidity of underlying assets and the investment horizon of each type of fund could be considered in particular and reflected in adequate labelling of the products.

**From an industry standpoint, asset managers should also ensure that they continuously adapt their investment techniques and processes** (e.g. valuation techniques, market risk evaluations,...) to face up to potentially poorly valued or illiquid assets. The industry should also make sure that products are designed in coherence with the promises made to investors in terms of investment horizon and liquidity and that they are correctly labelled and classified<sup>14</sup>.

<sup>7</sup> Eg decision to invest in certain countries

<sup>8</sup> Investing in different markets carries different risks: country risk (eg the risk of expropriation), market operational risk (eg the risk of markets ceasing to function in an orderly fashion), legal risk (e.g. the operation of insolvency laws and the functioning of the legal system of the country)

<sup>9</sup> The AIFM proposal states that the „depositary can only discharge itself from its liability in case of any loss of financial instruments if it can prove that it could not have avoided this loss“. This means that in the most extreme case depositaries would have to return assets held by a third-party agent whatever the circumstance, particularly in case of fraud or bankruptcy of this agent. Similar dispositions already exist in French regulation and have recently been applied following the Lehman default. This differs from obligations of the UCITS Directive which can be interpreted more as a obligation of means.

<sup>10</sup> since they may not be able to pass on these extra-costs to the fund manager

<sup>11</sup> Eg in the case assets would need to be reimbursed very quickly to investors leading to possible bankruptcy of a systemically important financial institution or when market risks are shifted onto depositaries. Possible requirements for immediate compensation would be even more difficult to implement and seem unnecessary since illiquid or depreciated assets at a moment in time are not lost and can increase in value

<sup>12</sup> Operational and business issues should be covered by the due diligence conducted. Asset managers should be able to evaluate “country” risks for markets with an inadequate structure or regulatory framework

<sup>13</sup> Once an investment enters a side pocket only the present participants in the fund will be entitled to a share of it

#### **4.2. The assessment of complex financial instruments by asset managers could be improved as well as the product development process**

Due diligence processes could be further codified, as well as product selection standards for wrapper products, to ensure that the assessment of complex instruments has been adequately conducted, taking into account different types of risks and the investment horizon.

Processes and tools used by asset managers for evaluating and selecting securities should also be reviewed as well as the platforms used to support investment in derivatives and structured products.

#### **5. Further standardization and automation of cross-border fund processing is still required to reduce operational risks in this area:**

Nearly half of cross-border fund orders are still processed manually, at least for part of the operations required to place and clear an order. Faxes, non standardized formats, etc... are still widely used. This is a source of extra-costs - manual orders cost at least 3 to 4 times more than automated ones - but also of operational risk with errors, misplaced orders, etc...

There are positive signs that the industry is building momentum in this area. Standardization initiatives conducted by Swift and different industry groups are underway<sup>15</sup>. Platforms such as Fundsettle, Vestima and service providers propose services to facilitate cross-border order processing with incentives in some cases for distributors to use them, Swift has also proposed new services targeting smaller distributors.

Much progress is however still required to achieve a critical mass of standardization and automation in order processing of around 80%. Several proposals made in previous Eurofi papers with the support of prominent industry players<sup>16</sup> could be considered to move this problem forward: committing to a roadmap endorsed by the main stakeholders of the industry to achieve 80% of automation and standardization by the time UCITS IV and the new Swift standards come into force (ie 2011 / 2012), closer monitoring and measurement of the progress made over time, mutualised incentives at market level to encourage the use of automated solutions by all types of distributors, a data repository at EU level comprising key information for fund processing, evolution of the local practices of Transfer Agents and CSDs to facilitate safe and automated cross-border processing of orders.

<sup>14</sup> Some of these measures are further detailed in the study conducted by the Asset Management Thinktank "Building long term savings in Europe" Jan 2009

<sup>15</sup> Swift is in the process of rolling out new ISO standards for messaging, EFAMA and Swift have built up statistics to help track the level of automation and standardization, the Fund Processing passport of EFAMA is being progressively rolled out, ISSA has also made standardization proposals, Eurofi has also worked on this issue with a wide variety of players and proposed a roadmap for reaching 80% of automation by the time UCITS IV is implemented...

<sup>16</sup> Eurofi paper presented at the Eurofi Financial Forum 2008 in Nice