Risk Oversight of Investment Activity

Twelve Pitfalls to Avoid

The key functional area in any investment management firm is the investment team. It is also the firm's primary source of risk. Executive management rarely has the time to review the investment activity of the firm directly, the legal and compliance teams often lack the necessary expertise to judge the intricacies of the investment process and the investment team itself has an obvious conflict of interest in overseeing its own activities. The solution to the core risk to the firm posed by the investment process lies in establishing and supporting an independent, skilled and properly resourced Risk Oversight function. Establishing a Risk Oversight function, particularly in an already well-established investment firm, can pose challenges for executive management – this white paper discusses the most important pitfalls to avoid.

INTRODUCTION

It is fair to say that when launched, the focus for most investment management (IM) firms is on establishing and selling its investment management process. Consideration of risk at the firm level is generally a concept that is introduced later, once the firm is established and growing. Even for IM firms that have been in operation for many decades, firm-level risk is likely a concept that was only introduced to their organization well after its founding.

Since risk at the firm level is a concept introduced after an IM firm is established, there will be competing interests within the firm that will seek to influence the creation of such a risk program. Certainly the IM department will take a keen interest, as will other Governance areas (Compliance and Legal) in the organization. Other functional areas such as Operations, Sales and Marketing may, depending on the firm and its people, want to have a say in the creation of any type of risk function in their firm, especially if they feel it will affect their areas of responsibility.

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The presence of competing and potentially conflicting interests at an IM firm at the time a risk program is introduced raises the possibility that a nascent risk program may be structured unwisely. This white paper reviews a dozen possible pitfalls that the executive management team of an IM firm should understand when creating any type of risk program for their firm. Even firms with long-existing risk programs would benefit from an assessment of their programs against the pitfalls discussed here.

Pitfall #1: Confusing Risk Management with Risk Oversight – In the process of constructing investment portfolios, managing investment risk is a critical step. It is one of several steps inherent to the investment process, including such other steps as securities analysis, asset allocation, market analysis, securities trading and the *ex post* analysis of past investment performance to improve future investment decision-making. All of these steps belong strictly in the domain of an IM department, headed by an investment professional that is held responsible for the firm's investment performance.

Risk Oversight of the IM function, however, is a distinct discipline that should be kept separate from the risk management function that needs to take place within the IM department. Risk Oversight personnel should be the eyes and ears of the firm's executive management team in monitoring investment activities. Risk Oversight is the direct extension of executive management exercising its fiduciary responsibility to clients and shareholders of the firm. As will be discussed in more tangible detail below, acceptance of the fact that portfolio risk management belongs in the IM department must not be confused with the need to establish true Risk Oversight as an independent function in the firm.

Pitfall #2: Have Risk Oversight Report to the Investment Head – Even accepting the idea that there is a difference between portfolio risk management and Risk Oversight, competing interests in the firm (particularly those most budget-conscious) may argue that the Risk Oversight function belongs under the control of the IM department. The fact that the IM department has a core competency in risk management may lead some to conclude that Risk Oversight can be combined with portfolio risk management and unified under the leadership of the firm's Chief Investment Officer (CIO) or equivalent. It may appear to some that the firm is duplicating its expenditures of resources by expecting the IM department to perform risk management and then hiring additional individuals, likely with very similar backgrounds, to do Risk Oversight of the same IM team. Certainly, it could be argued, there should be efficiencies to having just one Risk function for the firm, particularly with regards to IM activity.

Risk Oversight should not be placed organizationally within the firm's IM department. Risk Oversight is not a decision-making process for the IM firm. It is an arms-length review <u>of</u> the decision-making process conducted by the IM department (and more broadly other areas of the firm) on behalf of executive management. To draw a parallel, it would be fair in this case to compare the role of the Risk Oversight department with that of the firm's Compliance department. The fact that an IM department is expected to have a sufficient compliance expertise to make compliant investment decisions should NOT lead the firm to place its Compliance department under the control of its IM department, solely to minimize duplication of staff with the same expertise. Following a similar logic, just because the IM department presumably has an expertise in making risk management decisions for client portfolios should not imply that the firm's Risk Oversight function should be housed in its IM department.

It may also be confusing for executive management, in establishing a Risk Oversight function, to be advised that the risk function should be staffed by one or more senior individuals that have a strong background in investment management. Nevertheless, that similarity does not imply that Risk Oversight staff belongs within the IM department.

Preferably the independent Risk Oversight officer (or team) should report either directly to the CEO or to a member of the firm's executive team (perhaps the COO or General Counsel) – anywhere at the executive or board level that is independent of the IM decision-making function of the organization.

Pitfall #3: Allow Risk Oversight to Override Investment Decisions – Parallel to the idea that the IM department should not own or control the IM firm's Risk Oversight program, the Risk Oversight program, conversely, should NOT have unchallenged authority to cancel, postpone, modify or reverse any investment decision made by the IM department - at least not without the review and concurrence of executive management. There may be a temptation, particularly if the Risk Oversight team has senior members with very strong investment backgrounds, to believe that the IM firm will best be protected if the Risk Oversight team can "prevent or reverse a problem before it happens, or before it gets worse."

In point of fact any short-term benefit that might be derived by granting the Risk Oversight team veto authority to side-step the occasional bad IM decision will be offset by the long-term damage to the firm caused by "authority confusion." For all the many groups in the investment firm that rely on the CIO and the IM leadership for guidance (groups such as Sales, Marketing, Operations, junior investment personnel and even the executive management team), the lack of clarity that will result from "not knowing who really makes the final investment decision" will be palpable and damaging. Individuals may even fall into the habit of bypassing the CIO or the IM leadership team altogether, attempting, for example, to pre-clear investment ideas or marketing materials with the Risk Oversight team first, before consulting with IM, or perhaps not even developing such ideas or materials in the first place due to the confusion as to whether IM leadership will be overruled by Risk Oversight.

The role of Risk Oversight in a well-managed IM firm is much broader than any one single investment decision and should deliver its benefits at a much higher, much more consistent and much earlier level than at the point of any single trade or investment allocation. The Risk Oversight team should be reviewing patterns and attribution of investment performance, style drift, risk aggregation across products and programs, flaws or weaknesses in investment guidelines, risk exposures in proposed new products, etc. The Risk Oversight team should not be deployed to review or approve individual trades or allocations prior to their implementation.

This is not to say that individual trades or investment decisions made within the IM department cannot be reviewed, challenged or even subject to pre-trade approval or held in abeyance pending further review. However, this type of trade-level review should be assigned to the Compliance department of the IM firm, implementing a direct and tangible review procedure or testing protocol of well-written investment guidelines and trading procedures. Such guidelines and tests would, at a higher level, have been designed in part with input from the Risk Oversight team, but should be implemented by a well-staffed and well-trained Compliance department. Such pre-trade compliance reviews would ideally be buttressed by automated access for the Compliance team to submitted trades or allocations recommendations.

Pitfall #4: Allow Investment Staff to Lead Investment Review Committees – Characterizing the leadership of Investment Committees by IM staff as a "pitfall" will likely be the most controversial of all pitfalls discussed in this white paper. It is a timeworn tradition in the investment industry that the senior-most leader of the IM department, usually a CIO, organizes and runs any official investment committees of the IM firm. Such committees are variously named the Investment Policy Committee, the Investment Review Committee, the Investment Oversight Committee, etc., or just simply the Investment Committee.

There are in fact certain investment committees within an IM firm that <u>should</u> be overseen by the firm's CIO or equivalent. These are the true investment decision-making committees. Those committees that focus on determining, in advance, what investment decisions should be made belong unequivocally under the auspices of the IM department. Similarly, those committees that present for the purposes of analysis and investment decision-making the collected findings of any securities research, sector or market research, asset allocation analysis or what-if risk or scenario analyses, or that seek to learn lessons about future investment activity from past investment performance also belong under the control of the IM department. Such "committee meetings" are really just staff meetings of the IM department. To minimize confusion about its oversight fiduciary duty, executive management of an IM firm should request its IM department to not title such meetings as "committees" but rather as staff meetings.

On a related note, unless there is a compelling need to do otherwise, it isn't necessary that representatives of any other function in the firm be in attendance for such investment decision-making staff meetings, as these meetings are primarily internal to the investment function of the firm (indeed, eliminating the title of "committee" from these staff meetings will likely reduce the interest of unrelated parties to want to attend). And if certain non-investment personnel do attend to such investment decision-making meetings (especially staff from the Sales or Marketing departments), the IM firm should be VERY careful not to allow such non-investment personnel to vote on, decide or otherwise influence any matter regarding the firm's ongoing and future investment decision-making. Violations of the IM firm's fiduciary duties are far too easy to originate in such meetings when business-interested parties are permitted to participate actively in *ex ante* investment decision-making.

However, not every committee in an IM firm with the word "investment" in its title involves investment decision-making or warrants control by the IM department. Here are several clear examples: First, any committee designed to exercise *ex post* oversight of investment performance from a fiduciary or business perspective should <u>not</u> be organized or led by leaders of the IM department. Similarly, any committees designed to debate and determine the guidelines under which current or new investment products should operate should also <u>not</u> be led or controlled by IM leadership. And finally any committee devoted to the review of trading efficiencies or practices (so-called "Best Execution" committees) or the fair valuation of securities (Pricing committees) should also <u>not</u> be led by IM leadership, but should instead be led by corporate officers independent of the firm's IM leadership.

> *"Committees that exercise the the fiduciary responsibility for oversight in an investment firm should not be under the control of investment personnel."*

In essence, the rule being advocated here is a simple one: Committees that exercise the fiduciary responsibility for oversight in an investment firm should not be under the control of investment personnel. In this case "control" means setting the agenda, supervising the production of committee materials, chairing the meeting, leading the discussion, calling for any vote or approval and maintaining minutes of the meetings.

Investment personnel should certainly be in attendance at such meetings and should be called upon to discuss their results and defend their views. In this regard the best examples that IM firms can draw from in establishing their Investment Oversight Committees would be such oversight authorities as mutual fund boards, pension boards or bank trust committees. In these examples the oversight is both formalized and independent, with investment teams being invited to present their results and be questioned by board members and their staff, but often the IM leadership is then excused from the room to allow for separate "executive session" discussions by the committee members. Presentation materials, minutes, votes and other parliamentary activities are independently managed by the oversight committee in these cases, and serve as a good model for the executive management of an IM firm to follow in exercising oversight of its IM team.

Leadership of such oversight committees at an IM firm could reasonably be placed under an independent Risk Oversight officer or, in certain circumstances, under an appropriately independent member of the IM firm's executive committee. In all circumstances, however, a representative of the independent Risk Oversight team should be a voting member of, and active participant in, any committee that exercises an IM firm's fiduciary responsibility.

Pitfall #5: Give Compliance the Responsibility for Risk Oversight – This "pitfall" may in fact have certain exceptions, depending upon the organizational structure of the IM firm and the manner in which the firm has staffed its Compliance department. But by and large as traditionally structured and staffed, the typical Compliance department at an IM firm should not be tasked with Risk Oversight, especially not Risk Oversight of the investment function. This is not to say that a properly staffed Risk Oversight group cannot, for purposes of the firm's organization chart, report to the firm's Chief Compliance Officer (or equivalently to the firm's General Counsel). The point is that traditional Compliance personnel are generally not properly equipped to deal with Risk Oversight, particularly not the Risk Oversight of the IM function.

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There are two compelling reasons why the Risk Oversight function of an IM firm should not be performed by the firm's Compliance department. First, with regards to investment Risk Oversight, Compliance teams are generally not familiar with the arcana of investment decision-making, particularly such technical issues as performance and risk attribution. Second and more broadly, Risk Oversight and Compliance have a fundamentally different mindset as to what constitutes something of concern for senior management. Compliance very often deals with the world of what the investment firm CAN'T do; Risk Oversight more often deals with the world of what an investment firm CAN do but possibly SHOULDN'T do.

There is no section under regulatory law that spells out an inappropriate risk. The case for reining in risk at an IM firm cannot be made via an appeal to a regulation or statute, except possibly in the broadest of terms (i.e., an appeal to generic requirements of prudence and fiduciary responsibility). While various regulations and statutes may require an IM firm to act prudently, there is no specific guidance under the law, as there is with such Compliance staples as, say, personal trading or the advertising of performance, to help determine that an action is "too risky."

The regulatory agencies themselves are not helping IM firms to avoid this pitfall either. With their increasing emphasis that IM firms engage in what the regulatory agencies call risk management, the regulators are inadvertently sending a signal to investment firms that true Risk Oversight belongs in the firm's Compliance department (a similar trend by regulators of confusing Risk with Compliance appears to also be taking place within the rest of the financial services industry, including such areas as brokerage and banking).

Most investment firms view any stated stricture from their regulatory bodies as task items to be monitored by their Compliance departments. IM firms would do well, however, not only to keep the Compliance and Risk functions separate in their organization, but to view them as distinctly different sources of corporate advice as well.

Pitfall #6: Compensate Investment Personnel Based on Raw Investment Performance – IM personnel have a tremendous authority within an IM firm. They have the ability to make investment decisions on investment dollar amounts that are usually many times the size of the firm's capital base. Such investment decisions impose risks on clients and in turn impose risks on the IM firm. As will be discussed below, compensation of IM department personnel can affect their investment decision-making; thus the IM firm's decision as to how to compensate IM department personnel is fundamentally a risk decision, on many levels.

The common structure for compensating investment personnel is a mix of base salary and variable compensation, with the variable compensation tied to investment performance. Alternatively firms may tie variable compensation of IM personnel to revenues or to the level of managed assets, but variable compensation is most commonly tied to a measure of investment performance. And it is in the choice(s) of the metrics of investment performance to use for variable compensation decisions in which IM firms can take unnecessary risks.

The choice of investment performance bogeys for variable compensation may involve up to three broad factors: a time dimension, a benchmark dimension and a risk dimension. Predominantly it is a mix of these three factors.

The time dimension is the choice as to whether the investment performance bogey covers a short-term time period (a calendar quarter or year) vs. a longer-term measure (three years or five years). The benchmark dimension is the choice as to whether the investment performance bogey is measured on an absolute basis or as the difference between achieved performance and a passive market index. The risk dimension is the choice as to whether the investment performance bogey, whether absolute or benchmark-relative, is adjusted for the level of risk taken.

From the perspective of optimally managing the risk of the IM firm, there is a clear choice to be made in all three dimensions. First, unquestionably, if investment performance is to be used as a bogey for variable compensation, it should be measured on a risk-adjusted basis. Judging investment personnel on raw performance gives the investment personnel what economists call a "free call option." This means that if the investment decision-maker chooses to take excessive risk and their choice succeeds, they are remarkably well compensated. If they take excessive risk and fail, their variable compensation will be at worst zero. This separates the investment personnel from the client, who experiences actual loss, and from the firm, which may lose the client and the associated revenue from that client. The investment personnel simply fail to get a bonus, which means their interests are not fully aligned with those of the client or of the firm. And of course since they are not being judged on their level of risk taking, the excessive risks in this scenario will not be identified.

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Some IM firms have chosen to implement "claw-backs" to minimize this free call option but claw-back programs are easily "gamed" by investment personnel. Ongoing investment performance is well-known to all members of the IM firm at all times, so If the "writing on the wall" becomes clear to an IM department staffer (such as a portfolio manager) that a claw-back will be forthcoming due to weak investment performance, that staffer will move on to another firm.

Further undermining the usefulness of claw-backs is the fact that when investment personnel change firms mid-year, they often receive a mid-year signing bonus from the hiring firm to make up for the claimed "bonus they will miss that year for changing jobs." So claw-backs don't serve to motivate investment personnel to avoid excessive risk-taking, they only hurt the IM firm by triggering "key person risk," namely the unanticipated departures of key investment personnel when investment performance is facing challenge. Compensating on risk-adjusted investment performance all but eliminates this form of excessive risk-taking, assuming a proper bogey of risk-adjusted performance is chosen.

The choice for the benchmark dimension of a performance-related compensation bogey is also straightforward: the choice should be to use an index-relative measure of investment performance rather than an absolute measure of performance. This follows from the more general risk rule that in all its uses of investment performance (not just employee performance reviews) the investment firm should judge its success relative to a well-defined passive index measure. Indeed, ALL business activity in any firm should be judged against some form of benchmark. Firms are often judged against industry-wide financial ratios, the concept here with regards to investment performance is no different.

When absolute performance is the primary standard by which an investment firm defines its success, it is nevertheless human nature to mentally apply some form of benchmark on this raw performance, even when no passive benchmark for the performance has been declared. In the absence of intelligently chosen benchmarks, individuals in the IM firm will typically revert to judging raw performance against an implied benchmark. This implied benchmark is often zero (i.e., positive performance is good, negative performance is bad). This leads to bad decision-making across the firm, not just in judging investment performance but also in sales and marketing communications as well. The use of risk-adjusted absolute performance measures can mitigate some of this bad decision-making, but nevertheless there is always a value for an investment firm in putting the effort into reviewing, and choosing to use, a set of passive indices to serve as bogeys for the investment performance of their products. Applying such index-relative performance in the review of investment personnel and their compensation follows accordingly.

The final dimension to consider in choosing investment performance bogeys for variable compensation plans is the time dimension. Conventional wisdom holds that investment professionals should be held accountable for longer-term investment performance. A focus on shorter-term investment performance is widely believed to encourage imprudent investment decision-making.

Generally this would be true if raw investment performance was the metric of choice for the compensation review of investment professionals. However, when risk-adjusted performance against a properly chosen passive bogey is the metric of choice as recommended in this white paper, the encouragement to engage in imprudent investment decision-making is all but eliminated.

When properly adjusted for risk, short-term performance cannot be gamed by excessive risk-taking. If this is accepted as true, then by logical extension the best way to achieve long-term solid risk-adjusted performance is to string together successive periods of solid short-term risk-adjusted investment performance. And to do that, investment personnel should be compensated frequently based on short-term risk-adjusted performance.

Pitfall #7: Tie Compensation of Risk Oversight Staff to ANY Investment Performance – A well-staffed Risk Oversight function will preferably employ individuals with a strong background in investment management. As a result, there may be a temptation to continue the compensation patterns such individuals have known in the past, namely to tie their variable compensation to the level of the firm's investment performance.

This is, quite simply, a very bad idea. In this regard Risk Oversight personnel can be compared to Compliance personnel. Most firms understand intuitively that it is a bad idea to have the variable compensation of Compliance personnel (if variable comp is even offered to the Compliance department) tied to the firm's investment performance. To the extent that Risk Oversight personnel are part of the "Governance Triumvirate" (i.e., Risk, Legal and Compliance) of an IM firm, much like their counterparts in the Compliance and Legal departments, Risk Oversight personnel should not be compensated based on any measure of investment performance.

The IM firm should not want its Risk Oversight team to ally its thinking to the same conflict of interest (especially the "free call option") that can be faced by IM department personnel when those risk staff members are reviewing the appropriateness of investment decision-making for the firm.

Including Risk Oversight as part of the Governance Triumvirate of an investment management firm raises an interesting question, however: since Compliance and Legal personnel are often not compensated on any other measure of a firm's short-term financial success (revenue growth, AUM growth, quarter-to-quarter profitability, etc.), should the same hold true for Risk Oversight personnel? Unequivocally yes. Those who stand at arm's length to an investment firm's decision-making should not face the temptation to rubber-stamp business decisions that might offer short-term success at the expense of long-term loss. Members of the Governance Triumvirate, including Risk Oversight, if they are to have their compensation tied to business success at all, should have their compensation tied to longer-term measures of business success (particularly since shorter-term measures can't be as easily risk-adjusted as can investment performance). Ideally the best method of variable compensation for Risk Oversight would be equity grants or options. Not only are such tools tied to the very longest evaluation of the firm's long-term success, their valuation is made by individuals (shareholders or, for private equity, future buyers of the firm) who are at an even greater arms-length to the firm's decision-making process than the Risk Oversight personnel.

> *"Ideally the best method of variable compensation for Risk Oversight personnel would be equity grants or options.*

Pitfall #8: Assume Compliance Oversight of Sales and Marketing is Sufficient – A heavy portion of the duties of the Compliance team for an IM firm is devoted to ensuring propriety in the firm's sales and marketing efforts. As far as the interaction between the investment team and the Sales and Marketing teams is concerned, however, reliance solely upon the Compliance department may be insufficient. The Compliance team often must take the investment messaging of the IM firm at face value, which may not be a good assumption.

The reliance of an IM firm's Marketing team on the IM department is generally very heavy at most IM firms. At the very least, a robust Marketing department independently capable of investment messaging will still need to coordinate with the investment team to ensure that the investment message being developed in Marketing is consistent with actual portfolio activity conducted by the IM department. A smaller and less robust Marketing team will often rely more heavily on the IM department to craft the ongoing investment message. In worst case scenarios for some IM firms, the IM department is, for all intents and purposes, the true marketing function of the firm, while the small handful of individuals in the firm ostensibly forming the firm's Marketing department primarily deal with copy-editing, mock-up, document production and final distribution, but leave the development of the firm's investment messaging almost entirely to the IM department.

The risk faced by the IM firm in the interaction between the IM department and the Marketing team is a basic conflict of interest: the firm's marketing materials are usually an external effort to provide a "report card" on the efforts of the IM department. Allowing the IM staff to write such a "report card" on itself runs the risk of lack of balance at a minimum, misrepresentation in a worst case. For the same reasons that the IM department should not control fiduciary oversight committees of the firm (which provide an "internal report card" on IM activities), they should also not have the uncontrolled ability to craft the firm's external report card on IM activities.

An IM firm's Compliance team will often successfully identify and correct any lack of balance in marketing materials that gets past the Marketing team. However, neither Compliance nor the Marketing team is likely to identify a deliberate skew or even misrepresentation in the investment message if they themselves are not the original authors of the message, or if they don't have access to the information necessary to vet the marketing claims provided by the IM department.

Marketing materials that provide regular updates regarding an IM firm's investment products usually contain a host of claims and representations about market conditions, portfolio holdings, recently made investment decisions and, most importantly, a discussion of the sources and attribution of performance within a product or portfolio. These claims and representations are often provided to Marketing by the IM department. Neither the Marketing team nor the Compliance team usually has access to the information necessary to confirm or deny the claims supplied by the IM department.

An unspoken acceptance exists at most IM firms that such claims are accurate. Compliance focuses its time seeking to balance or temper the language of the claims being made, in accordance with a well-established regulatory law that prohibits excessively promissory or forward-looking claims or representations. Compliance rarely has the capacity to validate independently all of the claims being made, however, and unless the Marketing department has that ability, it likely won't be done.

The Risk Oversight team of an IM firm can and should be involved, along with Compliance, in the review of marketing materials, for two reasons. First, a well-staffed Risk Oversight team will have members with a strong investment background who are regularly reviewing the firm's investment activity. These individuals will be better positioned to confirm the veracity of claims made in ongoing marketing materials. Second, a properly established Risk Oversight team will, much like Compliance, have a degree of arms-length independence, not only from the investment personnel who are the source of the claims in the marketing materials, but also from the Marketing department itself, which can sometimes share the inherent conflict of interest of both the IM and the Sales departments in wanting marketing materials to portray the firm's activities and performance in the best possible light.

With regards to the review of marketing materials then, a Risk Oversight team can combine the knowledge of an investment team with the independence of a Compliance team in validating ongoing marketing materials.

Pitfall #9: Allow Investment Personnel to Control Middle- or Back-Office Activities – Most IM firms are clear on avoiding this type of risk, or believe they are. The notion that members of the IM department should not control such tasks as trade settlements, account reconciliations, collateral commitments or cash wires is very clear to the leaders of almost all IM firms. The classic example of going against this recommended separation of front-office from middle- and back-office functions would be the fall of Barings Bank in 1995, in which a proprietary trader in their Singapore office (Nick Leeson) was permitted to simultaneously oversee not just his own discretionary trading for the firm but also the reconciliation and margin maintenance of those same discretionary trading accounts.

But how strong is the front vs. middle/back-office separation in all IM firms? While firms often hold fast to the prohibition against involving investment personnel in matters related to cash and security accounting in client accounts, the lines of separation grow less clear for those middle- and back-office functions that are not directly related to accounting. Indeed, for some middle/back-office functions the involvement by and influence of investment personnel exists to a degree that may pose significant risk to the IM firm without any awareness by the firm's executive management. These areas of undue overlap between front- and middle-/back-office include:

- End-of-period pricing and valuation of securities owned in client accounts, particularly for more exotic instruments such as over-the-counter derivatives;
- Establishment of the rules by which performance measures are created for the firm, particularly rules regarding the construction of composites and selection of "representative accounts";
- Selection of approved brokerage firms with which market trading can be conducted and/or counterparties with which over-the-counter contracts can be engaged;
- Approval of new client accounts and determination as to program suitability for such new clients;
- Control over the degree to which intra- or inter-day cash overdrafts can be incurred as a result of trading;

- Determination of amount and type of securities which can be delivered or accepted as margin or collateral.

Each of these functions falls clearly in either a middle-office or back-office domain of an IM firm and most definitely would pose a severe risk to the firm if their functional responsibilities were left solely in the control of the firm's front-office IM department, due to the obvious conflicts of interest. Nevertheless it is common for investment personnel to have such strong influence over certain defined responsibilities of the middle- and back-office that they have in effect *de facto* control of these responsibilities.

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The reasons why IM firms might allow this *de facto* control to happen are myriad, but generally fall into either a "push" or "pull" type of explanation. Middle/back-offices are often pushed by members of the IM department to follow their wishes due to the strength of the IM department's interest in many of these functions (Nick Leeson at Barings Bank or Joseph Jett at Kidder Peabody being prime examples). This attempted influence manifests most often with broker selection, as traders and portfolio managers within the IM department who develop relationships with specific brokerage personnel (either at current or former places of employment), wish to continue, expand or ease restrictions on that brokerage relationship while at their current firm. Investment personnel may feel strongly on the matter and may strongly seek to influence middle/back-office personnel into going along with their choices for brokers and counterparties.

On the other hand, investment personnel may be pulled reluctantly into guiding certain middle/back-office decisions in which investment expertise is essential, such as pricing and valuation, or the vagaries of investment performance measurement. And while these "pull" requests may begin as innocuous requests for assistance, they pose risks for the firm nonetheless due to the conflict of interest the firm faces in allowing investment personnel to price their own holdings or to determine their own level of investment performance success.

Pitfall #10: Resist Efforts to Control "People Risk" – There seems to be a strange reluctance in the IM industry - perhaps in all industries – to willingly classify "People Risk" as a legitimate standalone risk concern. The possibility that the people who work for an investment firm might themselves be a source of risk to the firm is often resisted strongly by upper management.

Pushback against the identification of "People Risk" usually takes one of several forms. "I wouldn't have hired my people if I didn't trust them" is a refrain often spoken when a Risk Oversight team member tries to call attention to the issue of People Risk. An equally popular comeback to the highlighting of People Risk is for management to say "after all, we are all professionals and we know our jobs," somehow implying that once employees have a sufficient education level, have taken on a white collar job and have accumulated enough experience in the workforce they are no longer susceptible to taking excessive risks or making bad decisions. The preponderance of PhDs and Nobel-laureates at Long-Term Capital Management, or the 160-year existence in the industry of Lehman Brothers did little to help either firm avoid catastrophic ends.

In point of fact People Risk is quite possibly the most significant internal risk an IM firm can face. And since investment management is the mainstay of the modern IM firm, People Risk within the IM department is a key source of risk that must be acknowledged, prioritized, monitored and controlled.

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At a minimum one of the most important aspects of People Risk is the risk of Key Person Loss. Either through accident or intent, any worker at an IM firm can unexpectedly separate from the firm. The unexpected loss of a key member of an IM team is a critical People Risk that should always be near the top of any IM firm's risk self-assessment. And as mentioned previously, other forms of People Risk are ever-present for investment personnel: the incentive to take excessive risks, to maintain the primary spotlight only on successes, to influence middle/back-office operations or to downplay, or even worse to hide, performance failures is present at all times within an IM department and such People Risks need to be acknowledged without resistance by senior management.

Pitfall #11: See Tension between Risk Oversight and Investment Management as a Problem – Tension between the Risk Oversight team and the IM department is to be expected, and should not be looked upon by executive management as any kind of sign of institutional failure. In situations where neither the Risk Oversight team controls the IM department nor the IM department controls the Risk Oversight team, it is likely that a degree of constructive tension between the two groups will be common in areas where their responsibilities overlap.

This type of conflict between Risk and Investments will be different than the somewhat analogous tensions that can arise between Compliance and Investments, or between Legal and Investments. When conflict arises between the Investment team and either the Compliance or the Legal team, there is often a solid foundation by which the dispute can be resolved without the involvement of executive management. The Compliance team can generally call upon a substantial reserve of regulatory law and prior instances of a firm being admonished by a regulatory agency for a similar conduct. Likewise, the Legal department can usually cite any number of court cases in which firms have been sued (and lost) for a given type of disputed conduct. This is not to say that there are never gray areas for Legal and Compliance in dealing with investment activity, just that there are usually touchstones available to aid in resolution. Also, when all else fails, many firms have established some degree of veto power over certain investment decisions that can be exercised by Compliance or Legal, bringing at least some partial or temporary resolution to the situation.

Conflicts between the Investment team and the Risk Oversight team are rarely black-and-white and rarely as easily resolved as they are with Compliance or Legal. As discussed earlier, regulatory law and even case law is not always helpful in defining any specific behavior as "too risky." Similarly, since risk-taking is an essential element of an IM firm's success, the line is not always clear that an investment activity is "too risky," especially if that activity is technically within established guidelines.

> *"Regulatory law and even case law is not always helpful in defining any specific behavior as 'too risky'."*

It is the role of the executive management team, therefore, to make themselves available – indeed, even to establish a standardized forum - to assess and resolve tensions and conflicts that arise between Risk Oversight and the IM department. This involvement by executive management in any conflict between Risk Oversight and Investment Management is in fact the very definition of what is meant by the IM firm "adopting a risk culture."

Too often executive management perceives conflict between Risk Oversight and IM personnel as a sign of a problem with their firm's risk apparatus, or perhaps as a sign that there are just "personality conflicts" that can only be resolved either through the mediation of Human Resources or by changing staff. The expectation that the two groups should just "work it out like professionals" is more a sign of executive management's unwillingness to instill a risk culture in their firm than it is a sign of a problem with the risk apparatus itself.

Given that neither Investments nor Risk should have veto power over the other, and given that both investment decision-making and risk assessments are often subjective, disputes between the two groups should be expected. It is the role of executive management to arbitrate, on an ongoing basis, such risk conflicts, not to upend the firm's risk apparatus just because such disputes arise with regularity.

Pitfall #12: Assume the Risk Function will Identify and Control Risks – When establishing a Risk Oversight structure for its IM firm, executive management sometimes will conclude that the simple establishment of a fully-staffed risk structure is sufficient for the reduction of excess risk-taking by the firm. It is not.

The modern IM firm faces numerous risks not only related to its investment decision-making but also related to its many other functions enterprise-wide, including Operations, Marketing, and Sales. Expecting the Risk Oversight structure to identify and resolve all risks in the organization would require more resources than executive management is likely willing to devote. To identify and resolve all the risks in the firm the Risk Oversight team would have to be nearly as large, with as wide a variety of skills, as the firm itself. And that size level would be necessary simply to identify all the risks and their possible solutions. Resolving those many risks directly would require the Risk Oversight team to possess a level of authority equal to that of the executive management team itself.

No IM firm could operate profitably by creating a risk function that rivalled the size of the firm itself, or that gave that risk function a level of authority equal to that held by executive management. But without the manpower, expertise and authority of that order of magnitude, a Risk Oversight team will likely not be able to identify and resolve all risk issues – much less just the highest priority risk issues – all on its own.

The expectation for a Risk Oversight team should be more modest. It should be that they have sufficient resources and expertise to:

- Help executive management to articulate the level of risk appetite they want for their firm.
- Lay a foundation of policies and procedures for optimal risk-taking within the firm in keeping with that level of risk appetite.
- Assist the Compliance team in developing forensic testing programs against internally developed program guidelines.
- Review and conduct performance and risk attribution of the firm's investment positioning and performance.
- Work with senior stakeholders in the firm to establish Risk and Control Self-Assessment (RCSAs) programs within their areas of responsibility.
- Develop and monitor Key Risk Indicators (KRIs) as to the firm's progress towards lowering unwanted risks.
- When necessary, work with executive management to escalate and resolve those risks of the firm that are of the highest priority and that have failed to be resolved by the senior stakeholders.

CONCLUSION

The focus of this white paper has been to highlight and explain the pitfalls to be avoided in establishing a Risk Oversight function for an IM firm. An underlying theme of many of the pitfalls discussed has been to recognize that Risk Oversight is often introduced at an IM firm well after the firm has become established. Indeed, by the time executive management recognizes the need to introduce some type of risk structure for the firm the organization has already evolved to the point where functional silos exist. These silos generally include not just the investment function but also Sales, Marketing, Compliance, Operations, Performance Reporting, Finance and others. The firm will likely have already established various committees as well, such as investment committees, pricing committees, best execution committees, new product committees, budget committees, etc.

Given the presence of an established structure for an IM firm when Risk Oversight is introduced, it can be a challenge for executive management to decide the best way to introduce and empower the new Risk Oversight team. The potential that the Risk Oversight team will impact most if not all of the existing teams and committees opens the possibility that these teams will seek to advise on and influence

the creation of the Risk Oversight function. In some cases this influence may be to advocate for the charter of the Risk Oversight team to be designed more to protect current practices in the organization than to enhance the firm's overall commitment to its fiduciary responsibility.
The executive management team of an IM firm needs to recognize this challenge and nevertheless to establish the Risk Oversight function in a way that enhances the IM firm's commitment to its fiduciary responsibilities first and foremost. Drawing from the various scenarios presented in this white paper as to what to avoid, here is a more affirmatively focused summary of recommendations for the establishment of a new Risk Oversight organization:

1. Reporting - Select the appropriate org chart location for Risk Oversight. Ideally the Risk Oversight function should report directly to the President or CEO, or alternatively to the head of Compliance or the General Counsel. Potentially the group might report to a CFO or a Chief Operating Officer, but definitely not to a business-line head including Sales, Marketing, Investments or any revenue center of the business.

2. Corporate Title – The firm should be serious about establishing a true risk culture. The leader of the Risk Oversight team should be perceived as having access to and influence with the highest ranking members of the firm. Ideally that would mean providing a meaningful title, such as EVP and Chief Risk Officer or whatever corporate title represents seniority in the firm. If possible, the head of Risk Oversight should be a member of the firm's Executive Committee, if such a committee exists, or otherwise be introduced to the firm at an equivalent level.

3. Staffing – The ideal candidate to head Risk Oversight at an IM firm is someone with many years of experience as an IM professional. If the commitment to Risk Oversight includes establishing a multi-person team, then some team members can be hired with experience in Audit, IT or business strategy, but Risk Oversight for an IM firm should, first and foremost, have expertise in the detailed process of investment management.

4. Committee Membership – The head of Risk Oversight (or a senior member of the team) should have a voting seat on every committee in the IM firm that exercises the firm's oversight fiduciary responsibility. This would include not only investment review committees but also pricing, execution, new product approval and even budget committees and executive committees.

5. Authority – The Risk Oversight team should have the authority to collect information from any part of the firm, but should not have the authority to veto, overturn or stop any investment or business decision-making. In lieu of such direct control, the Risk Oversight team should have clear and unfettered access to the highest executive levels of the IM firm.

6. Duties – The Risk Oversight team duties may differ by firm, but could include:
    a. Creation and leadership of a risk management committee
    b. Establishment of an ongoing Risk and Control Self-Assessment program for all key areas.
    c. Development of Key Risk Indicators and related dashboards.
    d. Ownership of the performance and risk attribution process of the firm.
    e. Training and leadership for all areas on maintaining a risk culture.
    f. Active participation on all fiduciary committees
    g. Review of all product guidelines and investment policies.

Following these recommendations will help ensure that the Risk Oversight team helps optimize the IM firm's level of risk-taking.

All comments in this white paper are those of the author and may not be held by any organization with which the author may be currently or previously affiliated. To contact the author please feel free to reach him at:

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