

***ALFI Recommendations on the  
Risk Management System for Specialised Investment Fund  
in accordance to art. 42bis Law of 2007, as amended by the Law of 26 March  
2012 (hereinafter the “SIF Law”)***

The recent update of the SIF Law includes the requirement, in accordance to article 42bis, for each Specialised Investment Fund (“SIF”) to have appropriate risk management systems in place to identify, measure, manage and monitor the risks associated with the positions and their contribution to the overall risk profile of the portfolio.

By way of press release issued on 20 April 2012, the Luxembourg supervisory authority of the financial sector, the Commission de Surveillance du Secteur Financier (“CSSF”), has provided some guidance on how the newly required risk management system shall be implemented. In particular it requires that the SIFs must first of all provide the CSSF with a succinct description of the risk management systems implemented taking into account the proportionality principle in order to identify, measure, manage and monitor in an appropriate manner all the material risks to which the fund, or its compartments, are or may be exposed.

The following document shall, pending further clarification to be provided by the CSSF in the regulation in question (in accordance with Article 42bis, (3) SIF Law), provide proposals on how market participants may establish and document an adequate risk management system for SIFs. Upon adoption of further implementing measures by way of regulation from CSSF, ALFI will review this document and update it accordingly.

ALFI suggests to follow a 2 step approach when establishing an adequate risk management system for SIFs:

1. Define and document the risk management function
2. On the basis of the investment strategy of each SIF, identify the risks and define the appropriate measures, controls, limits and escalation procedures per risk category.

## **1. Risk Management Function**

The SIF should document how the risk management function is implemented and how the responsibilities for performing the tasks in relation to the risk management systems are allocated.

The CSSF provides that a description of the risk management function must be given that should cover the independence of the function **or** the specific protection measures taken to deal with conflicts of interest which ultimately allow the independent performance of risk management activities.

When considering the development of an effective and practical risk management system for SIFs it is important to consider the inherent characteristics of the operating models (i.e. operational risks) and of the assets.

Each SIF shall document on how it has established the risk management function that provides for implementing appropriate risk management systems. This includes documenting on who is responsible for the

maintenance of the risk management system in place, the interpretation of results as well as the final responsible taking ownership for such function within the decision making bodies of the structure (i.e. board of directors).

When defining the constituents of a risk management function, it is important to highlight the application of the proportionality principle, depending on the size, structure and complexity of the SIF.

The risk management function shall be functionally and hierarchically separate from the operating units, including from the functions of portfolio management. However, in applying the principle of proportionality independence could be also ensured by other means (e.g. measures to manage conflicts of interest) taking into account the size, structure and complexity of the SIF. The overarching structure of the SIF (e.g., existence of investment or risk committees) shall be taken into account.

Taking into account the characteristics of the SIF and the principle of proportionality, the risk management function may be organized in different ways – be it independent or with implementation of relevant measures to manage conflicts of interest. Below is a non-exhaustive list of persons or group of persons, who may assume the risk management function for a SIF, however ALFI considers this as a list of possibilities only and suggests to thoroughly analyse the characteristics of the SIF in order to determine on who may assume the risk management function: – for example:

- A member of the Board of Directors (“BoD”) or a Director<sup>1</sup> is specifically designated for overseeing the adequate performance of the risk management system (e.g., in case a member of the BoD is involved in the investment management function, i.e. investment committee, such member may also abstain from voting on investment decisions to further assure independence of the risk management function).
- An internal risk management team – not involved in investment decisions - ensures the adequate performance of the risk management systems.
- An employee of the Investment Manager – with access to relevant information - is specifically designated for ensuring the adequate performance of the risk management system – additional measures to manage conflicts of interests may have to be implemented.
- An external party is ensuring the adequate performance of the risk management systems.
- The Directors receive risk relevant reports and information from various sources and provides for the management and monitoring of risks.

If no direct independence can be assured, the SIF will have to implement specific protection measures, taking into account proportionality aspects, that mitigate conflicts of interest and assure independent performance of risk management activities (e.g., SIF sets up investor committees to deal with conflicts of interest situations). The protection measures implemented shall be documented.

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<sup>1</sup> « Directors » shall mean, in the case of public limited companies and in the case of cooperatives in the form of a public limited company, the members of the board of directors, in the case of partnerships limited by shares, the general partners, in the case of limited companies, the manager(s) and in the case of common funds, the members of the board of directors or the managers of the management company.

The relevant body<sup>2</sup> of the SIF shall be regularly (at least annually) informed about the risk management systems in place.

## 2. Risk identification, measurement and monitoring

The CSSF provides that procedures, processes and methods intended to measure and to manage in an appropriate manner the risks arising from the investment strategies and the risk profile of the fund (or from the compartments) shall be implemented.

To establish an appropriate risk management system, for each SIF one may perform the following steps:

- Determine the relevant material risks to which the SIF is or may be exposed (Identification)
- Determine the measurement / control method implemented for the risks identified (Measurement)
- Document the approach to limitation of risks (e.g., qualitative and/or quantitative limit criteria) and determine the required frequency of monitoring (Monitoring)
- Determine process for reporting and escalation in case of limit breaches (Management)

Each SIF will have to identify the specific and potential material risks associated to the portfolio positions that are to be covered within the risk management system.

Therefore, the SIF shall carry out a **process for risk identification** taking into account the risk profile / investment strategy of the SIF. The process shall clearly state the responsibilities for risk identification as well as the requirement to document the results of the risk identification for each SIF (e.g., identified major risk categories).

To provide a documentation for the risk management system implemented by the SIF according to the SIF Law, ALFI suggests to define **for each specific major risk category identified** the following relevant aspects:

- Assets concerned
- Description of measures/controls
- Approach to mitigate the risks
- Frequency of monitoring
- Reporting / Escalation
- Owner / Controller

Given the heterogeneity of the SIF universe, it is not adequate to define an exhaustive list of potential risk categories up front. It is under the responsibility of each SIF to define those risk categories that are relevant based on the risk profile and the investment strategy of the SIF - taking also into account proportionality principles.

Please find below a non-exhaustive example on how a risk management system for a SIF may be documented. Please note that the matrix set out below is only an exemplary format that could be used.

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<sup>2</sup> See footnote 1.

Example:

EXAMPLES ON IDENTIFICATION, MEASUREMENT AND MANAGEMENT OF RISKS						
RISK CATEGORY IDENTIFIED EXAMPLES	ASSETS CONCERNED	Description of measures / controls	Approach to Limitation of risks	Frequency of measurement	Reporting / Escalation	Owner / Controller
Market risk						
Credit risk						
Liquidity risk						
Transaction risk						
Valuation risk						
Operational risk						

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