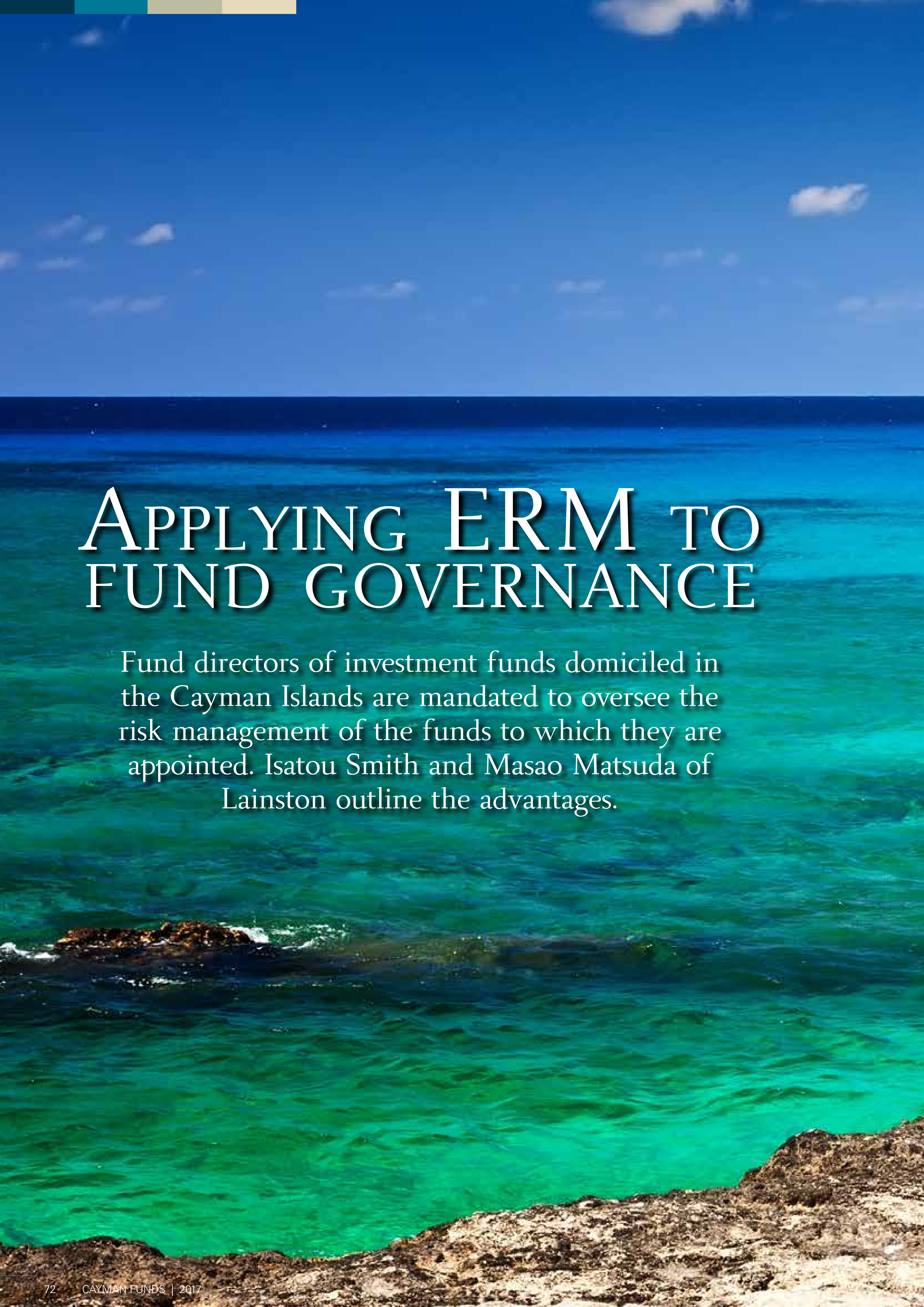

Applying ERM to fund governance

Fund directors of investment funds domiciled in the Cayman Islands are mandated to oversee the risk management of the funds to which they are appointed. Isatou Smith and Masao Matsuda of Lainston outline the advantages.

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Considering that the very objective of investment funds is to take risks for reward, it is not a leap to contemplate the role of enterprise risk management (ERM) for an investment fund.

Essentially, ERM is a means of value creation through integrated risk management applied to the entire business operation of an enterprise. While a typical definition of ERM presumes that ERM is applied to regular enterprises such as corporations, the major components of ERM are undoubtedly relevant to investment funds.

With this realisation, the question then becomes "Are most investment funds formally implementing it?" Moreover, as investment funds have no employees, one also has to consider whether the concept of ERM actually works for an investment fund and, if so, to determine the active parties, and where the process should be documented.

When the board of an investment fund contemplates the best way to undertake its oversight role of risk management of the fund, a primary point of reference is found in the *Statement of Guidance for Regulated Mutual Funds—Corporate Governance*, issued by the Cayman Islands Monetary Authority (CIMA) in December 2013.

The guidance lists the key responsibilities of the governing body of a fund, ie, operators (fund directors). Among other duties, the guidance describes the risk management oversight role of the fund directors in Paragraph 9.9 as follows:

"The operator should ensure it provides suitable oversight of risk management of the regulated mutual fund, ensuring the regulated mutual fund's risks are always appropriately managed and mitigated, with material risks being discussed at the governing body meeting and the governing body taking appropriate action where necessary."

Therefore, it is clear that for investment funds domiciled in the Cayman Islands, investment fund directors are mandated to oversee the risk management of the funds to which they are appointed. In this case, it is equivalent to serving as a board member of an enterprise and facilitating its ERM implementation, including overseeing a critical risk management process (RMP).

Risk-aware culture

An enterprise's board must play a leading role in setting and nurturing the risk-aware culture within an enterprise. In the case of investment funds, a board of directors "oversees" the risks involved in investment funds, and the fund's service providers, most notably the fund's investment manager, "manage" such risks. In order for ERM to be effective, the board's oversight responsibilities should include "setting the tone at the top". In other words, the board needs to ensure that the idea of risk-based governance is accepted and systematically implemented among relevant parties.

As investment fund managers are in the business of taking and managing investment risks, it should come as no surprise that an investment fund faces an array of investment-related risks. Addressing these risks constitutes the core competency of the investment fund manager, and investment fund directors should abstain from "managing" these risks. However, there clearly exist other types of critical risks that the investment fund directors ought to monitor and help mitigate, if appropriate. These risks include operational risk, liquidity risk, credit risk, and cybersecurity risk. As such, a fund board is obligated to "oversee" management of these risks including investment risks taken by an investment manager.

A unique aspect of fund governance lies in the fact that virtually any process of risk management involves various documents and service agreements. To illustrate, starting from the life of an investment fund, legal counsel drafts an investment fund's offering document, which delineates key risk factors. Another example is the investment manager's policy manual, which sets out various risk parameters including risk tolerance, as well as the types of risk a fund is exposed to.

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This manual should also document the parties involved in the risk management process and the frequency of their committee meetings. Reviewing these documents from the perspective of risk-based governance constitutes an important part of an investment fund director’s role as overseer.

Applying ERM

To effectively apply an ERM process to investment fund governance, several conditions need to be met. First, the investment fund’s board should make its commitment to ERM known to the investment fund’s investment manager and other third party service providers such as a fund administrator. As the investment fund generally seeks to have a solid risk management procedure in place irrespective of its adoption of ERM, this should not be a difficult commitment. Through this process, the investment fund’s board and top management of the investment manager can help to develop the risk culture of the investment fund they serve.

Second, the investment fund’s risk management policy should be articulated in a way consistent with the goal of ERM. Depending on the investment fund’s objective, the investment fund’s risk criteria and risk appetite will differ. Appropriate risk parameters such as value at risk (VaR), position limit, and leverage limit should be documented and the mechanism for conveying and reviewing “red-flag exceptions” should be delineated.

Just like the first condition, this should not pose a challenge, as an investment manager should have a solid risk management policy in place in any case. In some cases, the manager merely needs to go one step further to include the board in the chain of communication for critical and potentially critical matters.

Third, each element of the RMP needs to be followed judiciously. This means that the context is established, risks are assessed (identified, analysed and evaluated), and risks are treated in accordance with the risk assessment. There should also be a mechanism in place for direct information transfer between the investment fund’s board and the fund’s third party service providers. Direct access to important information sources such as fund accounting and portfolio risk reports will enable the investment fund directors to monitor the effectiveness of the RMP.

Fourth, in addition to periodic board meetings, investment fund directors need to maintain open communication with the key personnel of the investment manager. Mitigation of non-priced risk, eg, operational risk and cybersecurity risk, is most effective when the risk is detected prior to its materialisation. In addition, when an extreme market event occurs, it will become necessary to discuss with the investment manger the potential exercise of board discretion, under the governing documents, such as the imposition of redemption restrictions.

In the case of an investment fund, day-to-day investment decisions are not directly under the purview of its fund board. However, as is the case for a corporate entity, the responsibility of overseeing operational aspects of the fund lies on the shoulders of the fund board. As ERM addresses and integrates all the key aspects of fund operations, it is clear that applying an ERM framework becomes a *necessary* condition in fulfilling the responsibility of investment fund directors.

The payoffs

Does applying an ERM framework constitute a *sufficient* condition to meet a fund director’s responsibility? An ERM framework provides guiding principles so that an investment fund director can perform his/her duties in a systematic and conscientious fashion. Although there are nine sections in the Statement of Guidance mentioned earlier, only in the last and very brief section does the guidance address risk management.

Other sections, in addition to the statement of objectives and application, deal with responsibilities of oversight functions, conflict of interest, governing body meetings, operational duties, documentation, and relations with CIMA. On the surface, it may appear that risk management constitutes only a small part of an investment fund director’s responsibilities as stipulated by CIMA. However, the duties addressed in all these sections are important components of a typical ERM process.

This means that applying an ERM framework and diligently implementing the framework certainly covers all the fundamental responsibilities that are expected of investment fund directors by CIMA. As such, in order to fully comply with CIMA’s guidance, it is important to seek investment fund directors who can work with you in this process.

Investment fund directors should seek to protect the interests of investors in a way consistent with the goal of the ERM process for the fund. While the ultimate beneficiaries of an ERM framework are the investors, the service providers also gain from the value maximisation through ERM.

In effecting an enterprise’s ERM process, board members need to foster a risk-aware culture throughout an enterprise. Likewise, investment fund directors must exercise leadership in fostering a risk-aware culture for a fund.

Assuming that the required conditions are met, applying and implementing an ERM framework will go demonstrably beyond the fundamental responsibilities of an investment fund director and doing so will also contribute to maximising shareholder values—in other words, the fund’s net asset value.

To put it differently, a fund can be viewed as an enterprise, and applying an ERM framework is the surest way to lead to satisfied stakeholders for an investment fund. ■

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