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Opinion

Finding the Perfect Derivatives Risk Manager

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The Securities and Exchange Commission proposed in December a rule addressing the use of derivatives by registered investment companies. As part of the proposal, boards overseeing funds that invest in more than a limited amount of derivatives would be required to approve a derivatives risk management program and designate a derivatives risk manager.

This individual may have another role at the adviser, such as the chief compliance officer, but must be independent of the portfolio management function.

What will the derivatives risk manager do?

If the final rule is adopted as proposed, the derivatives risk manager would be responsible for administering the policies and procedures of the derivatives risk management program and reporting to the board on its effectiveness. A derivatives risk management program should include policies and procedures that:

- Assess the risks associated with a fund's derivatives transactions, including potential leverage, market, counterparty, liquidity and operational risks;
- Monitor the use of derivatives to ensure compliance with investment guidelines and portfolio limitations, including building or enhancing tracking systems and exception reporting for value-at-risk ("VaR") calculations, or other portfolio limitations and stress testing;
- Measure asset segregation; and
- Detail escalation procedures as material risks develop.

The board would be responsible for approving the program and reviewing written summaries prepared by the derivatives risk manager that report on the program's adequacy and how effectively it has been implemented. Because the subject matter may be very technical, directors cannot be expected to be experts in every derivatives-related issue.

Therefore, the board must be able to rely on the derivatives risk manager to fully understand how the derivatives risk management program works.

What attributes should the board consider when approving a derivatives risk manager?

As with other technical areas subject to the board's oversight, directors must be comfortable that the derivatives risk manager has the appropriate educational or vocational background and skills. The skill set will, of course, depend on the complexity of the fund's derivatives and how extensively they are used.

Directors should assess whether the derivatives risk manager understands the operational aspects of derivatives, such as trading and embedded costs. The individual also should understand the fund's investment strategy and the markets in which it operates so that the use of derivatives may be properly evaluated and the risks understood.

In addition, the derivatives risk manager should understand the purposes for using derivatives. He or she must be able to differentiate among hedging, exposure or other uses of derivatives and should be able determine or help determine how to best measure risk. The individual should understand VaR calculations, a highly technical area that has been incorporated into the required compliance testing for derivatives.

The derivatives risk manager must thoroughly understand the securities markets and how various instruments and strategies will behave in different market conditions. As part of the proposed rule, the program's asset coverage standards will be required to factor in whether coverage assets are sufficient to withstand "stressed conditions." The board will be looking to the derivatives risk manager for guidance on this topic, as well.

Because the role as proposed must be independent from portfolio management, the individual must have a good working relationship with the portfolio managers and must be conversant in investment strategies and concepts. He or she also must be assertive enough to address and escalate any concerns.

Finally, the derivatives risk manager needs to be able to communicate to the board and management about technical issues in a clear, concise and understandable manner – something that can be a challenge even for the technically proficient.

If the rule is adopted as proposed, the board will have to have confidence that the derivatives risk manager understands how derivatives behave in different market conditions, as well as in the fund's portfolio, and is capable of explaining and reporting on technical issues in a meaningful and articulate fashion. The person with all these attributes may very well be part of the portfolio management team – which is not allowed under the proposed rule. Hopefully the SEC will realize the obstacles that this exclusion would pose and will modify the rule accordingly.