



The old adage “every challenge is an opportunity” has been turned on its head for fund managers this year, says **Andrew White of Aquin Components**

The opportunity to trade across the EU that UCITS III now offers, along with the increasing use of the 130/30 approach to boost returns, has collectively given the fund management industry a wider world to play in across products and countries. The regulation will transform the fund management industry over the next few years and those expected to benefit most from this transformation are the funds that fully exploit the changing trading landscape.

But these opportunities are also challenges. The search for alpha has led fund managers toward increased use of complex and riskier instruments, while UCITS III has increased regulatory exposure for those funds operating in multiple geographies. If the potential benefits are to be realised, the rules and risks must be understood clearly and concisely.

OTC – OTT?

The murky risk exposure that collateralised debt obligations (CDOs) hold has been touted in the media around the world for a number of years and yet – when the true risk became clear – there were clearly some organisations that had

not got a grip on their position. This has affected players globally, both large and small, demonstrating the real challenge that complex derivatives can present, even to very experienced professionals. The sub-prime crash is just the latest example of the difficulty that asset managers face when dealing with complex instruments.

The buy side business is in the unenviable position of being at the end of a sales process and in no sales process does a product get talked down at any point. Being talked up at some stage is almost inevitable. This simple truth is reason enough for fund managers to consider their risk management capabilities to be their most important resource. An even more compelling reason to support this is the opportunities that strong risk management can present for growth – across products and geographies.

Almost inevitably, clients pushing for alpha lead to interest in riskier and more complex products. This is not necessarily risk that is understood either – CDOs could be considered, to quote Donald Rumsfeld “unknown unknowns”, as the complex structure and over the counter nature of the product makes their risk profile difficult to measure. This may well

lead to the holder of a security taking on risk without being aware of it. As such, the risk management function is no longer simply a box ticking exercise but an integral part of the ability to expand into what could be a profitable market – once the sub-prime debt issues are resolved.

Scope of regulation

On the compliance side, regulation in the form of UCITS III has pushed towards opening up borders as a market by providing a framework for players to operate in different geographies across the EU using complex instruments for the purposes of investing rather than purely for hedging. However, as with every ‘standard’, even in the case of law, there are variations in implementation, meaning, for example, that Germany and Ireland will have implemented the regulation in different ways.

Regulation is also a moving target – there have been variations in implementation across different countries but also, following a plethora of discussion and debate, a directive has been mooted to come into play in the EU for July 2008 to clarify the assets that a UCITS III compliant fund can use.

Geography is in fact a considerable challenge for any fund manager operating across countries, as numerous modifications to the regulations and directives imposed upon the industry are multiplied when different legal jurisdictions are taken into account. For fund managers that are working across these regions, the compliance challenge is a significant burden.

An example of this is the insistence that a fund must be run via a risk model, with the UCITS III product directive stating that: “The management or investment company must employ a risk management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio.” However, the required model may vary between legal jurisdictions – one may insist on value at risk testing (VaR), while another may require a different metric. In the case of the UK and Ireland for example, the latter limits the VaR for a fund running an absolute return model to 5%, while the former leaves the decision of what is appropriate to the discretion of

the fund.

If a fund is using derivatives, the VaR model is required, and to adequately calculate this will mean the risk management function uses the right process in-house to measure the broad range of risks that are present in all of the instruments traded – not easy in the case of OTC derivatives.

To ensure a system is not going to result in non-compliant trades, firstly, the organisational structure must be correctly deployed to monitor the trading process. The fund's senior management should establish an appropriate supervisory structure, involving a dedicated risk management team. They must ensure that the products used are

that they were previously not permitted.

United risk and compliance

Taking these factors into account, it would make sense that the risk and compliance departments work together in order to establish a trading position that rarely sees non-compliant trades or delays due to uncertainty. Less than half of fund managers have combined these two departments and instead are working on the tasks separately. Analogously this is like two people trying to row a boat without communicating – working on risk without a rules-based approach gives the fund manager an uncertain position, while appearing to move forward.

Almost inevitably, clients pushing for alpha lead to interest in riskier and more complex products

fully understood by the fund manager and that the system deployed to monitor these products use is also suitable.

The separate roles of risk and trading functions should be clearly delineated. Where complex securities are being used, the monitoring system may require the utilisation of new data feeds that support an internal – or at least independent – verification of pricing. Data from the product supplier is not sufficient. When one considers that MiFID will also be coming into play as of 1 November 2007, price formation may be further challenged. The likely fragmenting of liquidity that will occur as off exchange trading begins (or increases depending on the country) also creates a challenge for buy side firms that have relied upon a few trusted data sources for dealing in equities.

The removal of the concentration rule makes off exchange trading possible across the EU and thus the prices at which trades occur will be found in an increasing number of locations, giving fund managers the headache of aggregating this data. The regulatory environment will also likely drive innovation in product development and fuel cross border competition, as asset managers move into the space traditionally dominated by hedge funds and the hedge funds themselves are able to sell products to the retail environment

Aquin's MIG21 system combines the two challenges and provides a single interface for gathering and pooling this information. Tied to any preferred supplier of market data, MIG21 enables a fund manager to establish their real position, while maintaining an up to date grip on the very latest regulatory situation. With its Lawcard service, Aquin offers a team of dedicated individuals that feed relevant regulatory changes and decisions to MIG21's users as a compliance news feed including rule changes in the compliance system, thus removing the challenge of non-compliance while supporting the risk area of the fund.

The potential benefits of this are two-fold. First, it assists the risk manager in understanding what may be subtle variations in regulatory approaches between countries and develop a risk management approach that is appropriate. This is vital if the fund is to trade acceptably in an environment in which it is not domiciled. Where a fund is interested in moving into new jurisdictions such rapid adaptability is vital as it reduces training requirements, sourcing requirements and potentially difficult legal situations – plus associated costs.

Second, the improvements to risk management give a fund manager the confidence to trade complex products

across these geographies, which, following the sub-prime crash, will be a welcome relief.

A few years ago, risk management was not a 'favoured son' for buy side firms, yet now it may prove to be the breadwinner, providing resilient to hard knocks and offering its fund the chance to take each commercial opportunity as it appears.

About Aquin

The Aquin Group (www.aquin.com) is the expert in investment compliance. Our goal is to provide solutions, which increase the efficiency and competitive position of our clients, enabling them to provide comprehensive client services and maintain prudent operational and regulatory controls. Aquin's reputation has been built on the combination of financial business knowledge, IT expertise and long term client relationships. MIG21 is the market leading investment compliance and risk monitoring software. MIG21 optimises ex-ante and ex-post checking and administration of legal, contractual and internal investment guidelines for asset management companies, advisors, custodians & insurance companies. With MIG21 LawCards, customers are always in full compliance with latest changes in the world's major investment jurisdictions, including UCITS III and SEC 1940.

Aquin services a blue chip client base including the world's leading investment management companies including, among others, CACEIS Bank/Fastnet, Citigroup, Credit Suisse and State Street, as well as five of the top six German asset managers: Deutsche Bank/DWS, Allianz Global Investors, Commerzbank/ComInvest, HVB/Pioneer Investments and Union Investment.

The company has its headquarters in Frankfurt am Main and subsidiaries in Zurich, Paris, Luxembourg, London, Dublin and New York and will open up an office in Boston at the end of this year.