

Chapter 3

Requirements for alternative investment fund managers

3.7 Risk management

Application

3.7.1 **R** This section applies to a *full-scope UK AIFM* of:

- (1) a *UK AIF*; and
- (2) [deleted]
- (3) a *non-UK AIF*.

Functional and hierarchical separation

- 3.7.2 **R**
- (1) An *AIFM* must functionally and hierarchically separate the functions of risk management from the operating units, including from the functions of portfolio management.
 - (2) An *AIFM* must, in any event, be able to demonstrate that:
 - (a) specific safeguards against conflicts of interest allow for the independent performance of risk management activities; and
 - (b) the risk management process satisfies the requirements of this section and is consistently effective.

[Note: article 15(1) of *AIFMD*]

- 3.7.3 **UK**
- Functional and hierarchical separation of the risk management function
1. The risk management function shall be considered as functionally and hierarchically separated from the operating units, including the portfolio management function, only where all the following conditions are satisfied:
 - (a) persons engaged in the performance of the risk management function are not supervised by those responsible for the performance of the operating units, including the portfolio management function, of the *AIFM*;
 - (b) persons engaged in the performance of the risk management function are not engaged in the performance of activities within the operating units, including the portfolio management function;
 - (c) persons engaged in the performance of the risk management function are compensated in accordance with the achievement of the objectives linked to that function, independently of the performance of the operating units, including the portfolio management function;

2. The functional and hierarchical separation of the risk management function in accordance with paragraph 1 shall be ensured throughout the whole hierarchical structure of the AIFM, up to its governing body. It shall be reviewed by the governing body and, where it exists, the supervisory function of the AIFM.

[Note: article 42(1) and (2) of the *AIFMD level 2 regulation*]

3.7.4

UK

Safeguards against conflicts of interest

1. The safeguards against conflicts of interest referred to in the UK legislation that implemented Article 15(1) of Directive 2011/61/EU shall ensure, at least, that:

- (a) decisions taken by the risk management function are based on reliable data, which are subject to an appropriate degree of control by the risk management function;
- (b) the remuneration of those engaged in the performance of the risk management function reflects the achievement of the objectives linked to the risk management function, independently of the performance of the business areas in which they are engaged;
- (c) the risk management function is subject to an appropriate independent review to ensure that decisions are being arrived at independently;
- (d) the risk management function is represented in the governing body or the supervisory function, where it has been established, at least with the same authority as the portfolio management function;
- (e) any conflicting duties are properly segregated.

2. Where proportionate, taking into account the nature, scale and complexity of the AIFM, the safeguards referred to in paragraph 1 shall also ensure that:

- (a) the performance of the risk management function is reviewed regularly by the internal audit function, or, if the latter has not been established, by an external party appointed by the governing body;
- (b) where a risk committee has been established, it is appropriately resourced and its non-independent members do not have undue influence over the performance of the risk management function.

3. The governing body of the AIFM and, where it exists, the supervisory function shall establish the safeguards against conflicts of interest laid down in paragraphs 1 and 2, regularly review their effectiveness and take timely remedial action to address any deficiencies.

[Note: article 43 of the *AIFMD level 2 regulation*]

Risk management systems

3.7.5

R

- (1) (a) An *AIFM* must implement adequate risk management systems to identify, measure, manage and monitor all risks relevant to each *AIF* investment strategy and to which each *AIF* is, or may be, exposed.
- (b) In particular, an *AIFM* must not solely or mechanistically rely on credit ratings issued by credit rating agencies, as defined in article 3(1)(b) of Regulation (EC) No 1060/2009 of the European

Parliament and of the Council of 16 September 2009 on credit rating agencies, for assessing the creditworthiness of the *AIF*'s assets.

- (2) An *AIFM* must, at least:
- (a) implement an appropriate, documented and regularly updated due diligence process when investing on behalf of the *AIF*, according to the investment strategy, objectives and risk profile of the *AIF*;
 - (b) ensure that the risks associated with each investment position of the *AIF* and their overall effect on the *AIF*'s portfolio can be properly identified, measured, managed and monitored on an ongoing basis, including through the use of appropriate stress testing procedures; and
 - (c) ensure that the risk profile of the *AIF* corresponds to the size, portfolio structure and investment strategies and objectives of the *AIF* as set out in the *instrument constituting the fund, prospectus* and offering documents.

[Note: article 15(2) first paragraph and article 15(3) of *AIFMD*]

- 3.7.5A** G An *AIFM* should use the form in ■ SUP 15 Annex 6C R to notify the *FCA* of any material changes to the risk management policy and of the arrangements, processes and techniques referred to in article 45 of the *AIFMD level 2 regulation*, as required by article 41(4) of the *AIFMD level 2 regulation*.

Review of risk management systems

- 3.7.6** R An *AIFM* must:
- (1) review the risk management systems with appropriate frequency and, in any event, at least once a year; and
 - (2) adapt them whenever necessary.

[Note: article 15(2) second paragraph of *AIFMD*]

Maximum leverage levels

- 3.7.7** R
- (1) An *AIFM* must:
 - (a) set a maximum level of *leveraging* which it may employ on behalf of each *AIF* it manages; and
 - (b) where the *leverage* arrangement allows the right to reuse *collateral* or the granting of a guarantee, set out the extent of that right or guarantee.
 - (2) An *AIFM*, in complying with (1), must take into account relevant matters including:
 - (a) the type of *AIF*;
 - (b) the investment strategy of the *AIF*;
 - (c) the sources of *leverage* of the *AIF*;

- (d) any other link or relevant relationship with other financial services institutions which could pose systemic risk;
- (e) the need to limit the exposure to any single counterparty;
- (f) the extent to which the *leverage* is collateralised;
- (g) the asset-liability ratio; and
- (h) the scale, nature and extent of the activity of the *AIFM* on the markets concerned.

[Note: article 15(4) of *AIFMD*]

3.7.8 **R** An *AIFM* must demonstrate that the *leverage* limits it sets under **■ FUND 3.7.7R (1)(a)** are reasonable and that it complies with those limits at all times.

[Note: article 25(3) first sentence of *AIFMD*]

3.7.9 **G** To comply with **■ FUND 3.7.8 R**, an *AIFM* should report to the FCA any changes to the *leverage* limits it sets.

Subordinate measures

3.7.10 **G** Articles 6 to 11 of the *AIFMD level 2 regulation* provide detailed rules on the calculation of levels of *leverage*, articles 38 to 47 of the *AIFMD level 2 regulation* provide detailed rules on risk management and article 112 of the *AIFMD level 2 regulation* provides detailed rules on circumstances when *competent authorities* may impose *leverage* limits or other restrictions on the management of AIFs.