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COMMISSION SYNDICALE CONSULTATIVE
AUPRÈS DE L'ORGANISATION DE COOPÉRATION
ET DE DÉVELOPPEMENT ÉCONOMIQUES

Comments on the revised IOPS / OECD Good Practices on Alternative and Derivatives Investments by Pension Funds

Paris, 31 January 2010

1. TUAC welcomes the opportunity to submit written comments on the draft revised OECD / IOPS "Good Practices on Alternative and Derivative Investments" (DAF/AS/PEN/WD(2010)14) following the 25th session of the OECD Working Party on Private Pensions in November 2010. What follows are comments and suggestions for further amendment of the text. These can be regrouped under three headings:

- To acknowledge the challenges created by the many regulatory gaps that – still – characterise the industry as well as by the excessive use of leverage financing;
- To develop further guidance on the practical aspects to risk management and internal governance from a board perspective;
- To strengthen the requirements of independence of the risk officers and the consultancies involved in outsourcing activities.

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Definitional and regulatory issues

2. A difficulty with the paper stems from the need to cover a wide range of instruments and investment opportunities that are grouped under the heading "alternative and derivative investments". Paragraphs 2 and 3 note the significant variation in the complexity and risks associated with different parts of this realm and stress that "there is no clear-cut definition of alternative investments". That may be true for the term "alternative investment" itself, however the Good Practices could usefully reference existing definitions for some of the core components of the alternative investment classes. For example the BIS "glossary of terms used in payments and settlement systems"[1] and the OECD Monetary and Financial Issues, Economics Glossary[2] have generic definitions for derivatives[i] and for hedge funds[ii].

3. These references would be welcome also because they point to the light regulatory approach to and the many regulatory exemptions that have benefited and still characterise the alternative investment industry. Despite recent efforts to strengthen regulation of the OTC and traded derivatives and of hedge funds as part of the G20 and FSB process, this light regulatory treatment still prevails in the alternative investment world. In our view it constitutes a severe

[1] BIS Committee on Payment and Settlement Systems - A glossary of terms used in payments and settlement systems http://www.bis.org/publ/cpss00b.pdf?noframes=1
[2] http://www.oecd.org/glossary/0,3414,en_2649_34115_1968510_1_1_1_1,00.html#1967419

barrier to effective risk management by pension funds (and other institutions investors). These regulatory gaps are acknowledged implicitly in section 5 of the draft ("Supervision of Pension funds alternative investments") where supervisors are called upon to deepen their "own understanding" and "collect specific data" and in annotation 3.1; but they are not in other key sections of the draft, including section 1 on risk management.

More guidance needed on the decision making process

4. The draft offers a number of reasonable statements and objectives. We are particularly supportive of Section 3 ("Due diligence of external asset managers"), section 4 ("Communication") – including GP4c and its annotation 4.3 on disclosure of the fees – as well as sections 5 & 6 on supervision and regulation. It offers insufficient guidance however on the more practical aspects of pension board processed, including when information is incomplete and/or not all conditions are met for pension boards to take key decisions with regard to alternative assets and derivatives. This is particularly true for sections 1 & 2. Examples are given by GP1d ("All significant risks relating to the pension fund's alternatives and derivatives investments need to be measured and integrated into the pension fund's risk management system") and GP2a ("The pension fund's governing body needs to ensure that it has sufficient knowledge and expertise and adequate resources in place (both human and systems technology) before it decides to implement a policy on alternatives and derivatives investments"). These good practices and their corresponding annotations (1.6 and 2.1) are hard to object to. What would be important however is to further develop guidance in imperfect situations, e.g. in which above-mentioned "*all* significant risks" precisely cannot be easily measured or in which the trustees do not "fully understand" by using standard quantitative tools and on how those limitations should be taken into account in decision-making. The complexity of the issue clearly does not help, but any revision to the current draft should, we believe, move in that direction.

Leveraging

5. While the dangers of leveraging are mentioned in the introduction (paragraphs 2 & 8) and in the annotations to the section 6 (para. 6.1), they are not in the other sections. Given some of the problems that have arisen with respect to credit derivatives and with hedge funds, it would be worth mentioning the need to incorporate leveraging risk in risk management (section 1) and due diligence (section 3).

Independence of the risk officers

6. Annotation 2.3 calls for "adequate segregation of the funding responsibilities for measuring, monitoring and controlling alternative and derivatives investments from those conducting day to day derivatives transactions". Another annotation (also numbered "2.3") states that "A direct reporting line between [the control] function and the governing body is therefore of paramount importance to address any major risks in the fund's alternatives investments and derivatives positions". These are valuable propositions which need to be emphasised in the text and hence be 'upgraded' from annotation to stand-alone good practice. Indeed for the governing body to exercise leadership in assessing risks (as required by GP2a & GP2b), it needs to have full assurance about the independence of the risk officers vis-à-vis senior management which, by their very functions, will have more expertise on risk issues than the Board and may have incentives to take on a different and often more aggressive approach to risks than that of the board. Furthermore the need to ensure proper independence of the risk officers from senior management – both in terms of their remuneration and accountability to the board – also is raised in the OECD "Conclusions and emerging good

practices to enhance implementation of the Principles of Corporate Governance" (February 2010)[iii], in the FSB Principles for Sound Compensation Practices (April 2009) [iv] and their Implementation Standards (September 2009)[v].

Outsourced activities

7. In lien with the above, the paper offers a number of comments on the need for pension funds to take responsibility for risks that arise when investment functions are outsourced (GPe and annotations 2.5). Just as they need external auditors, pension trustees need external free-of-conflict advice on risk assessment and policy to constructively challenge senior management. Annotation 2.5 stresses the importance of the selection and assessment process of the external advice/consultancy benefiting from the outsourcing. It should be added that the risk assessment process itself be conducted by the risk officers (and not by the business unit that is proposing to use the outsourced investment service).

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[i] **BIS definition** "a financial contract the value of which depends on the value of one or more underlying reference assets, rates or indices. For analytical purposes, all derivatives contracts can be divided into basic building blocks of forward contracts, options or combinations thereof." **OECD definition** "A security whose value depends on the value of other basic underlying securities. Examples are futures and options, which are traded on organised exchanges, and forward contracts, swaps and other types of options, which are regularly traded outside of organised exchanges in what are termed over-the-counter markets."

[ii] **BIS definition** "a private investment fund, often leveraged, and often engaging in active trading strategies (including arbitrage). Hedge funds are typically subject to limited regulatory oversight." **OECD definition** "A pooled investment vehicle that is privately organised and is administered by professional investment managers. It is different from another pooled investment fund, the mutual fund, in that access is available only to wealthy individuals and institutional managers. Moreover, hedge funds are able to sell securities short and buy securities on leverage, which is consistent with their typically short-term and high risk oriented investment strategy, based primarily on the active use of derivatives and short positions. US hedge funds are exempt from Securities and Exchange Commission reporting requirements, as well as from regulatory restrictions concerning leverage or trading strategies."

[iii] Paragraph 39 of the **OECD Conclusions** reads "It is considered good practice that risk-management and control functions are independent of profit centres and the "chief risk officer" or equivalent should be able to report directly to the Board along the lines already advocated in the OECD Principles for internal control functions reporting to the audit committee or equivalent." http://www.oecd.org/dataoecd/53/62/44679170.pdf

[iv] **FSB Principle n°3** reads "Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm. Effective independence and appropriate authority of such staff are necessary to preserve the integrity of financial and risk management's influence on incentive compensation."
http://www.financialstabilityboard.org/publications/r_0904b.pdf

[v] **FSB Implementation Standard n°2** reads "For employees in the risk and compliance function: (i) remuneration should be determined independently of other business areas and be adequate to attract qualified and experienced staff; (ii) performance measures should be based principally on the achievement of the objectives of their functions". http://www.financialstabilityboard.org/publications/r_090925c.pdf