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Risk Management Issues for Registered Investment Companies

by Stephen H. Bier and Matthew A. Wolfe

The market events beginning in the summer of 2007 and their impact on the investment management industry has resulted in an increased focus on risk management and oversight by registered investment companies and their boards. While this focus has not yet resulted in new regulatory obligations, a number of fund groups have recently taken steps to address risk management in a more systematic and transparent manner. At the same time, numerous legislators, regulators and others have spoken in favor of some type of systematic risk regulator and it is possible, if not likely, that there will be legislative and regulatory efforts to insert this function into our financial regulatory system. With or without this type of macro-level systematic risk regulation, what should investment companies be doing now with respect to risk management?

For example, should investment companies and/or investment advisers be required to appoint chief risk officers much like they are required to appoint chief compliance officers? If not, are there other ways for the risk management function of funds and advisers to be formalized or otherwise addressed in a more comprehensive manner? This article will explore these issues.

In considering risk management for investment companies, a good place to start is with the Investment Company Act of 1940 (the Act) itself. The Act was adopted in large part to combat a number of abusive practices that occurred prior to regulation. While many of these practices related to outright fraudulent behavior and overreaching by fund sponsors, Section 1 of the Act also enumerates certain practices that were viewed as excessively risky, including "excessive borrowing and the issuance of excessive amounts of senior securities" that "unduly increase the speculative character of their junior securities," operating "without adequate assets or reserves" and more generally employing "unsound or misleading methods."[1]

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Many sections of the Act specifically mandate risk reducing conduct. Section 5 requires an investment company to classify itself as either "diversified" or "non-diversified" and, if diversified, to keep at least 75 percent of its assets in specified investments without investing more than 5 percent of its total assets in any one issuer or owning more than 10 percent of the voting securities of such issuer. Section 8(b)(1) requires an investment company to recite, in its registration statement, its "fundamental" policies which include their diversification status as well as other potentially risky investment practices, including: borrowing money; the issuance of senior securities; engaging in the business of underwriting securities issued by other persons; concentrating investments in a particular industry or group of industries;[2] the purchase and sale of real estate and commodities; and making loans to other persons. Section 13 marries the risk management and disclosure aspects of the Act by prohibiting a presumably safer diversified company from becoming non-diversified, and preventing an investment company from changing its other fundamental policies without shareholder approval.

Section 12(d) of the Act places limits on acquisition by investment companies of securities of other specific businesses. Of particular note, Section 12(d)(3) makes it unlawful, subject to certain exceptions, for a registered investment company (or a company controlled by the investment company) to purchase or otherwise acquire any security issued by or any other interest in the business of any person who is a broker, dealer, underwriter, or an investment adviser. The strict prohibition on owning securities issued by "securities related issuers" was, among other things, designed to protect investors from the risks of investing directly in the securities industry.

This strict prohibition is mitigated by Rule 12d3-1(b) under the Act, which permits such investments, but which places limits on a fund's investments in a "securities related issuer," including that not more than 5 percent of the fund's total assets may be invested in any one such issuer's securities. Thus even without an explicit risk management program, an investment company has a built-in means of counterparty risk management that resulted in limiting its exposure to such organizations as Lehman Brothers and Bear Stearns. In addition, because most over-the-counter derivative instruments are issued by entities subject to Section 12(d)(3), investment companies are forced to seek multiple counterparties for their derivative transactions.

Section 17 includes a number of provisions that relate to risk management. Section 17(g) requires funds to obtain a fidelity bond to protect the fund against outright misappropriation. Section 17(f) requires funds to maintain custody of their securities with a bank or with a broker-dealer; however, custody with a broker-dealer is subject to additional Securities and Exchange Commission (SEC) regulation pursuant to Rule 17f-1.

While the drafters of the Act did not necessarily envision Bernie Madoff, broker-dealers are subject to much more onerous custody requirements than banks. For example, Rule 17f-1 requires, among other things, assets custodied with broker-dealers to be verified for each semi-annual reporting period and, once a year, by a surprise audit. The requirements under Rule 17f-1 are viewed by broker-dealers as so onerous that broker-dealer custody of investment company assets is exceedingly rare. Instead, funds will typically utilize a tri-party arrangement between a bank, broker-dealer and the investment company to avoid the broker-dealer custody of fund assets.

Section 18 of the Act regulates the capital structure of both open- and closed-end investment companies placing limits on borrowing and on the ability of closed-end funds to issue senior securities. Open-end funds are prohibited from issuing any senior securities. Section 18 also includes specific asset coverage requirements for these borrowings and senior securities.

Beginning in the late 1970s, the SEC and its Staff addressed the leveraging impacts of a number of different transactions not explicitly addressed in Section 18, including reverse repurchase agreements, standby commitments, when-issued securities, written options, swaps, futures contracts, forward currency contracts and short sales in a release and subsequent no-action letters.[3] In short, this guidance interpreted the Section 18 prohibition on issuing senior securities to apply to transactions that could leverage fund assets unless a fund "covered" its obligations under these transactions by either entering into offsetting transactions or by maintaining sufficient liquid securities to adequately meet its obligations under these transactions. While this is conceptually a simple concept, it can present operational challenges to monitor properly. In addition, interpreting how to properly cover an obligation may raise questions of both compliance and credit risk. For example, in certain circumstances, a fund may cover its current exposure based on the "mark-to-market" value of the position as opposed to the notional value of the instrument which can be considerably higher.

Another area where regulation was designed to address potentially risky practices is the

compensation of investment advisers. Through the Investment Advisers Act of 1940's (Advisers Act) restrictions on performance fees, advisers to registered investment companies are prohibited from charging performance fees except for "fulcrum" fees where the performance fees may be adjusted equally upward or downward in relation to the performance of an appropriate index, or in cases where all investors in a fund meet the standards of a "qualified client" in Rule 205-3 (for example, $1.5 million in net worth).[4]

"The performance fee prohibition was included in the Advisers Act because of Congressional concern that performance fees created incentives for advisers to take inappropriate risks in managing a client's account in order to increase advisory fees."[5] These concerns regarding risk are combined with potential conflicts of interest where an adviser manages both asset-based and performance fee accounts. This led the SEC to adopt rules requiring that fund registration statements provide disclosure regarding compensation received by fund portfolio managers, both for managing the registered investment company as well as other accounts.[6] While these restrictions date back to the inception of the Act and the Advisers Act, recent studies on risk management have focused on the effects of improperly incentivized compensation.

Fund Compliance Programs

The provisions discussed above force investment companies to implicitly address risk management issues to ensure compliance with the Act. More recently the SEC's adoption of Rule 38a-1[7] requires that investment companies develop what is functionally an up-to-date risk management program for compliance risks. This rule requires investment companies to adopt compliance policies and procedures reasonably designed to prevent violations of federal securities laws, appoint a chief compliance officer (CCO) who reports to the fund's board and administers the compliance program, and to conduct an annual review of the implementation and effectiveness of the compliance program.

Although legal and compliance risk is one component of a full risk management program, the approach set forth in Rule 38a-1 provides a useful template for a more comprehensive risk management program. For example, it covers the investment company's service providers (adviser, principal underwriter, administrator, and transfer agent) and involves the management of these service providers in the implementation of these policies and procedures. At the same time, it requires oversight by the investment company's board and provides a specific framework for this oversight with a single individual, the CCO, charged with responsibility to administer the program. In addition, the protocols that have been developed for compliance testing and reporting have tended to utilize a risk-based approach to compliance, with those areas perceived to carry the highest risk being subject to more frequent and detailed testing and oversight. As discussed below, recent commentary and studies on risk management practices prescribe a similar enterprise level framework to fully cover a firm's entire risk inventory.

What's the significance of considering the risk mitigating nature of certain provisions of the Act? First, it can provide valuable evidence regarding how well this statutory scheme has functioned to address risk during recent market events. While there has been specific focus on the problems relating to money market[8] and target date funds,[9] both the SEC and others might consider going beyond these specific areas of concern and looking more broadly at how well the Act has functioned during the recent market crisis. Perhaps a more granular assessment of specific provisions, such as the concentration and diversification limitations, the impacts of Section 12(d)(3) and Rule 12d3-1, or the anti-leveraging requirements of Section 18 would provide useful information. Portfolio theory and concepts of risk management have certainly evolved since 1940. While the SEC and its Staff have utilized their rule-making and interpretative authority to keep the Act as current as possible, an analysis of such questions as whether these provisions have functioned as intended and whether the Act provided the necessary flexibility to efficiently engage in hedging or other risk mitigating techniques, among others, could provide useful data to investors and the industry.

Second, even for funds that have not yet addressed risk management in a comprehensive fashion (and recent studies suggest that such firms would be far from alone)[10] the risk mitigating provisions of the Act can provide a useful framework for developing a stronger risk management program. By complying with the Act, a fund will have already begun to address counterparty risk, liquidity risk,[11] valuation risk, compliance risk and a number of other risk areas.

Applying the Lessons from the Recent Financial Crisis

The events of the recent financial crisis offer useful guidance to investment companies and their service providers with respect to risk management.

In the wake of recent market events, there have been a number of recent studies, articles and other commentary that address risk management issues. While this commentary is not specifically intended to address registered investment companies and, in some instances, was even targeted to other financial services firms, nevertheless, in reviewing the literature, there is a clear consensus regarding certain best practices and lessons learned that could be beneficially applied to investment companies and their service providers with respect to portfolio management issues for advisers, operational issues for other service providers and to fund boards in carrying out their oversight function.

Enterprise-Level Risk Management

In March 2008, the Senior Supervisors Group, which consists of banking and securities regulators from France, Germany, Switzerland, the United Kingdom and the United States,[12] issued a report entitled *Observations on Risk Management Practice during the Recent Market Turbulence* (the SSG Report). The SSG Report surveyed risk management practices of various firms worldwide and highlighted the "risk management practices that may have enabled some firms to weather the financial market turmoil better than others."[13]

The SSG Report underlined the responsibility of senior management for implementing and emphasizing a firm's risk management practices, evoking the need to set a "tone at the top" and the importance of a firm-wide approach to risk management. A major fault of some firms included pressure from senior management to generate earnings without guidance on what the appropriate level of risk tolerance should be. While the SSG Report looked at these attributes with respect to "earnings," the same analysis could apply for investment companies by replacing "earnings" with "investment performance."

The SSG Report emphasized the need for senior management teams as a whole to include people with expertise in a range of risks, given the unpredictability of market disruptions. The Group found that firms are more likely to maintain a risk profile consistent with the board and senior management's tolerance for risk if they establish risk management committees that discuss all significant risk exposures across the firm, meet on a frequent basis, and include executive and senior leaders from key business lines and independent risk management and control functions—for example, the chief financial officer and senior managers from the legal function and operations areas—as equal partners. A good example of this enterprise-wide approach in practice would be a situation where an adviser's portfolio manager would like to invest in a complex financial instrument such as a collateralized debt obligation (CDO). Before doing so, it is important for the adviser to have a process in place to ensure that the fund has the operational capabilities to value the instrument and that the legal department has reviewed the CDO documentation to ensure that the terms of the instrument match the portfolio manager's expectations with respect to issues such as subordination and other rights.

Firms with less hierarchical structures and more direct channels of communication with senior managers received better risk information from their employees. The breadth and depth of internal communication across a firm was also critical to risk management success, and the study encourages firms to avoid organizational "silos" that compartmentalize information. Another commentator also observed that most firms did not have fully developed risk management programs in place during the recent financial crisis and utilized silos rather than an enterprise wide risk management approach.[14]

Many of the points raised by the SSG Report were also reflected in a 2007 speech entitled "Risk Management for Broker-Dealers" by Mary Ann Gadziala, Associate Director of the SEC's Office of Compliance Inspections and Examinations (OCIE). Ms. Gadziala noted that OCIE found that senior management involvement in making key risk management policy decisions and documented periodic review of firm wide limits or risk levels for authorized business activities was essential to successful risk management.[15]

Similarly, a recent white paper issued by Deloitte[16] noted that overall responsibility for risk management belongs with the CEO, and that in many financial institutions, a chief risk offer, or "CRO," position has been established that provides leadership for and executes the organization's risk management plans. Under this view, senior management—with board input and approval—is the responsible party for setting the institution's risk appetite, and clearly communicating it throughout the organization.

Another area where senior management participation in the risk management process is crucial is compensation. As the SSG Report observed,

> An issue for a number of firms is whether compensation and other incentives have been sufficiently well designed to achieve an appropriate balance between

> risk appetite and risk controls, between short-run and longer run performance, and between individual or local business unit goals and firm-wide objectives. Many firms are assessing their overall financial performance for 2007 and, in light of their results, reevaluating their approaches to performance-driven compensation and other incentives going forward.[17]

Even though the Advisers Act protects an investment company by restricting an investment adviser's ability to receive performance-based compensation from the registered fund, senior management at investment adviser entities should carefully evaluate their company's internal compensation structure to insure that it is not unduly incentivizing risk-taking behavior by its employees.

Board Oversight

While fund boards cannot be involved in risk management on a day-to-day basis, a board certainly should oversee the risk management processes of a company and be satisfied that such processes are adapted to the board's corporate strategy and are functioning as directed.[18] Fund boards should be asking fund management how fund officers and top management of key service providers are addressing risk management issues in their activities, particularly with respect to how these activities impact the funds themselves.

A board's oversight duty under Delaware law is subject to the *Caremark* standard which provides that there will be no director liability unless there is a lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight.[19] As noted in a paper authored by Wachtell, Lipton, Rosen & Katz (the Wachtell Paper), the cases that followed *Caremark* made clear that there would no liability unless directors intentionally failed to implement any reporting and information system, or the directors intentionally refused to monitor such a system, or act on any red flags that arose.

Nevertheless, while it may be extremely difficult to prove a breach of fiduciary duty for failure to exercise oversight, the Wachtell Paper suggests that boards should be aware that what constitutes a red flag and/or conscious disregard may in the future be evaluated with heightened scrutiny given the prominence of risk management issues in the current environment.

In addition to state corporate law, fund director duties for risk oversight may be shaped by other laws and guidelines. For example, the Wachtell Paper notes that when determining the effectiveness of financial controls or in the certification of financial statements in compliance with the Sarbanes-Oxley Act of 2002, a board should inquire as to whether material risks are identified and disclosed as part of the process. In addition, closed-end funds are often listed on the New York Stock Exchange (NYSE), and therefore subject to NYSE rules. NYSE rules explicitly require an audit committee to "discuss guidelines and policies to govern the process by which risk assessment and management is undertaken."

The penultimate concern of the board in this area is for the company's risk management process and overall risk management system to be not only adequate for compliance purposes, but effective in the actual operations of the company. Material risks must be adequately identified in a timely manner and risk management strategies must be responsive to the company's specific material risk exposures. The Deloitte paper goes so far as to advocate a written, clear, detailed, and board-approved risk management charter or framework that defines risk management roles and responsibilities. What is most important, though, is that throughout the company, business decision-making should include consideration of risk and risk management and the company should have policies and procedures that ensure that necessary information with respect to material risks is adequately transmitted to senior executives and, as appropriate, to the board or relevant committee.

Applying these principles to investment companies, advisers and other key service providers should compile a risk inventory applicable to the investment companies, and senior management and boards should ensure processes are in place to address all identified material risks.

As noted by the American Bar Association Committee on Corporate Law,[20] risk oversight is often delegated to a board committee, rather than undertaken by a board directly. Audit committees are most commonly utilized for this role, but boards should consider creating a committee specifically dedicated to risk oversight or at least ensuring that any standing committee has dedicated meeting times to address risk management issues. Because the full board is ultimately responsible for risk oversight, the full board should also receive information about the company's risk management system and the most significant risks that the company faces. In order to achieve this, the board, or committee charged with risk oversight, should have executive sessions with the managers primarily responsible

for risk management, which should be provided with appropriate information. The Deloitte paper even suggests that such sessions might be conducted "off the record" to encourage candor.

Specific Areas of Focus

The following are examples of recommendations to manage substantive risk areas that need to be addressed at a firm-wide level. While not tailored specifically to investment companies and their advisers, the analysis and advice below with respect to valuation risk and credit risk is largely transferable.

Valuation Risk

A firm's valuation process and abilities are always a concern of the board and management, and central to risk management, as recognized by both the SSG and Deloitte publications. The reports underline the importance of a firm's ability to value and measure the risk associated with all transactions. The SSG Report suggests that firms should have a more active approach to verifying their valuations using internal resources in a coordinated, centralized fashion. This report also recommends that firms enforce discipline internally in marking their assets to their estimated prices, using consistent marks across both proprietary positions and financed counterparty positions. The SSG Report even suggests that during periods of market turmoil it is helpful for firms to test the accuracy of their valuations through, among other things, selling a sufficient portion of their exposure to observe an actual market price and monitoring disputes over the market value of collateral posted by counterparties to help mark their own holdings of the same or similar securities.

Investment advisers should review their policies to consider these types of issues. This could include assessing the methodologies used to value certain types of complex instruments held by a fund (for example, derivatives and asset-backed securities) as well as considering enhancements to procedures for testing valuations provided by third parties, such as valuation services. If this review results in proposed changes to fund valuation policies, this would require board approval, and the implementation of these changes would also likely require coordination with other fund service providers to ensure that operational issues are properly addressed.

The practice of testing valuations of illiquid products against actual trade prices can reveal valuation anomalies that can provide an early warning signal to risk managers about valuation model errors and changing market conditions. OCIE has also found that internal audit departments can play a large role in effective risk mitigation by establishing the appropriate cycles of review and effectively monitoring timely corrective action responsive to audit findings. For investment advisers that do not have an internal audit function, this review could be undertaken by compliance, the fund administrator, or even a third party consultant.

Valuation of over-the-counter derivatives, such as structured credit products, is particularly challenging, especially as such valuation has moved to model-based efforts instead of transaction-based information, often creating less reliable valuations and greater pricing risk. The SSG Report suggests firms should give particularly thorough consideration to the interplay of the market sensitivities of derivative exposures, notional limits, value-at-risk (VaR), static single-factor stress tests, and historical and forward-looking scenario analysis. The commonly-made simplifying assumption made in some models that correlation between the prices of certain instruments will follow historical relationships is often detrimental. Many firms are planning to change the volatility estimates in their VaR methodologies to make them more sensitive to volatility spikes. Among the biggest problems with current valuation practices identified in the Deloitte paper was that valuation and monitoring measures of structured credit trading positions often do not adequately evaluate the underlying collateral, leading to underestimated risk exposures. Some valuation and risk models fail to use current spread information and do not build newer, complex products into the existing risk infrastructure. Other models use assumptions that attempt to map complex instruments to general index type exposures, thereby ignoring the products' specific risks. Continuous and thorough analysis of this nature should be done internally by the investment adviser to identify weaknesses and anomalies. To the extent that this analysis results in enhancements to its processes, management should bring both the identified problems and proposed solutions promptly to the board's attention, and a continuing dialogue with the board should be undertaken in evaluating the success of the implemented responses.

Market and Credit Risk

In addition to the risks attendant with respect to investment in difficult to value instruments, all

types of firms are subject to the general risks of the marketplace and inherent in dealing with counterparties. Of course, the degree to which a firm is subject to such risks has a lot to do with market cycles, as well as the unique business practices of the firm. With respect to the recent market turmoil, the top four sources of systemic risk cited in Deloitte's survey were: increased use of leverage to finance investments, credit risk cycles and asset valuation bubbles, the inability of markets and regulators to identify excessive aggregate risk and the increase in linkages and interconnectedness of markets produced by globalization. Having precise and effective risk management tools in place at a firm-wide (that is, adviser) level *before* these types of systemic risks loom large are crucial to the successful navigation of risk in the marketplace over time.

One risk that can be particularly important for investment advisers to properly consider is basis risk or correlation risk within an asset class, as well as correlation risk more broadly. As noted in the SSG Report, some firms are reconsidering what should be treated as a true hedge for risk management objectives. The use of both "conditional" and "unconditional" measures of market risk to provide information and limit risk was found to be beneficial. Additional risk measures that have been taken include those that reflect differences in assumed levels of correlations between market variables in benign versus stressed market conditions. All types of firms need sufficient abilities to identify consolidated, firm-wide, single-factor stress sensitivities, and concentrations.

Firm-Specific Risks

As OCIE's survey found, a firm also needs to be mindful of risks arising in its own day-to-day operations. Firms should have an effective reconciliation process to ensure data integrity and completeness, and should consider having a dedicated group and/or committee effective in identifying and establishing controls for operational risks. OCIE recommends integrating all systems and material operational risks in reports to and discussions with senior management. As the Deloitte paper also notes, firm-wide consistent approaches to data, models, and processes are necessary to compile an aggregated view of the firm's risk. Of course, it is more helpful if the models themselves cover all types of risks—liquidity, credit, market, and valuation risks, in addition to new products, overlooked exposures and new and emerging risks. With respect to an investment company, a board should inquire of its service providers with respect to these firm-specific risks and ascertain how new products (for example, the launch of a new fund) would be incorporated into these risk management processes.

An obvious but important point to take away from the varied studies on risk management in the wake of the recent financial crisis is that the effectiveness of government regulation and self-regulation of firms through their implemented risk management frameworks is mainly driven by compliance with the discrete provisions of such regulations and frameworks. To successfully manage risk, firms must not only have complete up-to-date written legal and compliance policies and procedures, but they must also effectively monitor and surveil compliance and legal issues. Key ingredients to successful risk management mentioned by OCIE, for example, include legal and compliance committee approval participation for new and high-risk business, products or transactions, the clear assignment of authority and responsibility for legal and compliance, and a strong overall compliance culture at the firm. As noted above, the requirements of Rule 38a-1 afford investment companies a large head start to accomplish this, although funds and their service providers can be expected to go deeper into this process.

Transparency and Disclosure

Related to all compliance and risk management framework issues raised herein is the importance of providing clear, easily understood, risk-related information to the outside world in an appropriate level of detail. The legal and compliance functions of registered investment companies know the basic SEC guidelines for the type of risk disclosure they are required to provide to their investors. However, it is also important for fund operations and management personnel, including portfolio managers, to be fully informed of the risk profile of the products that they are overseeing or managing as it is presented to the public, and to conduct investment operations accordingly. Transparency and disclosure are enhanced if management is actively involved in creating and updating risk disclosure. As discussed throughout this article and in others, senior management is ultimately responsible for setting the company's risk standards, and thus a regular review of risk disclosure is useful in encouraging management to effectively articulate those standards. As the Deloitte paper suggests, senior management should actively monitor contingent exposures and be prepared to take action. Identifying important potential risks and

providing clear information about those risks is a necessary part of a company's risk disclosure process.

Conclusion

Risk management in the financial services sector has been subject to increased scrutiny following recent market events. Although practices vary widely by firm, studies have shown that many firms have not yet fully developed comprehensive enterprise wide risk management programs. With respect to investment companies, the Act provides funds and their service providers some level of built-in risk management architecture that is needed to comply with a number of the Act's compliance requirements. Recent developments should provide an incentive for investment companies and their service providers to bring these programs to the next level with respect to being more comprehensive, and better integrated, and developing a more formal reporting and oversight structure at the Board level.

NOTES

1. *See* Sections 1(b)(7),(8) and (5) of the Act.

2. SEC Staff guidance further provides this policy must commit a fund to investing either more or less than 25 percent of its assets in such an industry or group of industries. *See* First Australia Fund, Inc., SEC No-Action Letter (pub. avail. July 29, 1999).

3. Inv. Co. Act Rel. No. 10666, (Apr. 18, 1979); Dreyfus Strategic Investing & Dreyfus Strategic Income, SEC No-Action Letter (pub. avail. June 22, 1987); Merrill Lynch Asset Management, L.P., SEC No-Action Letter (pub. avail. July 2, 1996); *see also http://sec.gov/divisions/investment/seniorsecurities-bibliography.htm.*

4. Advisers Act Section 205(b)(2) and Rule 205-3 thereunder.

5. *See* "Protecting Investors: A Half Century of Investment Company Regulation," SEC's Division of Investment Management (May 1992) at 237 (*citing* H.R. REP. No. 2639, 76th Cong., 2d Sess. 29 (1940)).

6. *See Final Rule: Disclosure Regarding Portfolio Managers of Registered Management Investment Companies;* Release No. 33-8458; (Aug. 23, 2004).

7. *See Compliance Programs of Investment Companies and Investment Advisers,* Release Nos. IA-2204; IC-26299 (Dec. 17, 2003) (SEC release adopting Rules 38a-1 and Rule 206(4)-7 under the Advisers Act).

8. *See, e.g.,* "Report of the Money Market Working Group," Investment Company Institute (March 17, 2009).

9. *See* SEC Press Release, "SEC, DOL Accepting Requests to Participate in Joint Hearing Examining Target Date Funds" (May 22, 2009).

10. S. Bainbridge, "Caremark and Enterprise Risk Management," *UCLA School of Law, Law-Econ Research Paper No. 09-08* (March, 18 2009) (the Bainbridge Article). Bainbridge notes that risk management was largely undeveloped among financial firms when the market crisis took hold.

11. *E.g.*, illiquid holdings are limited to 15 percent for open-end funds, and 10 percent for money market funds.

12. While representatives of the SEC were part of this group, there were no representatives of the Division of Investment Management listed.

13. Senior Supervisors Group, "Observations on Risk Management Practices during the Recent Market Turbulence," March 6, 2008 (SSG Report). Note that the period covered by this study concluded at year-end 2007.

14. *Bainbridge Article, supra* n.10 (*citing* Betty Simkins & Steven A. Ramirez, "Enterprise-Wide Risk Management and Corporate Governance," 39 *Loy. U. CHI. L. J.* 571, 577–586 (2008).

15. Speech by SEC Staff: "Risk Management for Broker-Dealers," 2007 AICPA/FMD National Conference on the Securities Industry, New York, NY, Nov. 28, 2007.

16. "Risk management in the age of structured products: Lessons learned for improving risk intelligence," produced by the Deloitte Center for Banking Solutions.

17. SSG Report, *supra* n.13.

18. Wachtell, Lipton, Rosen & Katz, "Risk Management and the Board of Directors" (Nov. 2008) (Wachtell Paper); *see also* "Corporate Directors Guidebook," American Bar Association Committee on Corporate Law (5th Ed. 2008).

19. In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del Ch. 1996).

20. Corporate Directors Guidebook, *supra* n.18.

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