REGULATORY GUIDE 259

Risk management systems of fund operators

October 2022

About this guide

This guide is for Australian financial services (AFS) licensees that are responsible entities or corporate directors (fund operators).

It gives specific guidance on how fund operators may comply with their obligation under s912A(1)(h) of the *Corporations Act 2001* (Corporations Act) to maintain adequate risk management systems.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This guide was issued in September 2022 and is based on legislation and regulations as at the date of issue.

Previous versions:

- Superseded Regulatory Guide 259 *Risk management systems of responsible entities*, issued March 2017

Disclaimer

This guide does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this guide are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

Contents

A Overview

Key points

As Australian financial services (AFS) licensees, responsible entities of registered managed investment schemes (registered schemes) and corporate directors of corporate collective investment vehicles (CCIVs) are legally obliged to have adequate risk management systems. These systems are fundamental to mitigating exposure to relevant risks and informing business decision making.

This guide provides guidance on how fund operators may comply with this obligation, including:

- establishing and maintaining risk management systems that are suitable for the fund operator's business and the funds operated (see Section B);
- identifying and assessing risks (see Section C); and
- managing risks (see Section D).

Legislative obligation

RG 259.1 Under s912A(1)(h) of the *Corporations Act 2001* (Corporations Act), responsible entities of registered schemes and corporate directors of CCIVs (fund operators) have an ongoing obligation to maintain adequate risk management systems.

RG 259.2 In Regulatory Guide 104 *AFS licensing: Meeting the general obligations* (RG 104), we set out our general guidance for AFS licensees on what is required to comply with s912A(1)(h).

RG 259.3 This guide provides guidance on specific areas to improve the risk management systems of fund operators.

What this guide covers

RG 259.4 This guide outlines our expectations of fund operators when complying with the obligation within s912A(1)(h).

RG 259.5 While RG 104 gives guidance on risk management systems for AFS licensees generally, this guide focuses specifically on the business of fund operators, the registered schemes and CCIVs (funds) they operate and the particular risks they face.

RG 259.6 The sections of this guide detail our expectations for fund operators to have:

(a) overarching risk management systems in place (Section B);

(b) processes for identifying and assessing risks (Section C); and

(c) processes for managing risks (Section D).

We expect these systems and processes to be appropriate for the nature, scale and complexity of the business and funds operated.

RG 259.7 We have also included in this guide additional good practice guidance. This guidance is not mandatory; it is intended to help fund operators improve their risk management systems to operate at a level above their statutory obligations.

RG 259.8 Table 1 provides a summary of our expectations of fund operators and the good practice guidance.

Table 1: Summary of guidance

Section	Expectations for compliance with s912A(1)(h)	Good practice guidance (not mandatory)
Section B (Establishing a risk management system)	Fund operators should: • maintain documented risk management systems that include: – clearly defined roles and responsibilities; – policies and procedures for identifying, assessing and understanding each of the material risks of the fund operator's business and funds operated; – policies and procedures for ensuring there are adequate controls in place to manage the risks identified; – policies and procedures for ensuring there is adequate oversight of the risk management systems by both the party responsible for ownership of the risk and the compliance function, including appropriate reporting; and – a policy or statement on the fund operator's risk appetite and the risk tolerance for each material risk identified; • foster a strong risk management culture; • take into account relevant industry, local and international guidance; • include, as a component of the risk management systems, a liquidity risk management process; • review their risk management systems—to ensure that they are current, relevant, effective and complied with—as frequently as appropriate, given the nature, scale and complexity of the fund operator's business and the funds it operates (at a minimum, annually); and • if relying on external service providers for risk management functions, maintain a strong understanding of risk management and have sufficient skills to independently monitor and assess the performance and ongoing suitability of the service provider.	Fund operators may: • at least every three years, conduct a comprehensive independent review of the appropriateness, effectiveness and adequacy of the risk management systems; • segregate functions to allow for independent checks and balances; • establish a designated risk management function and/or risk management committee; • appoint a chief risk officer; and • publicly disclose a summary of the key aspects of the fund operator's risk management systems.

Section	Expectations for compliance with s912A(1)(h)	Good practice guidance (not mandatory)
Section C (Identifying and assessing risks)	Fund operators should: • maintain one or more risk registers as part of their risk identification and assessment process; • ensure that their risk management systems address all material risks—including (but not limited to) strategic risk, governance risk, operational risk, market and investment risk, and liquidity risk—at both the fund operator and fund level; • when choosing methodologies for identifying and assessing risks, take into account: – the nature, scale and complexity of the business; – processes based on forward-looking analysis; – ensuring an appropriate level of human input; – ensuring senior management involvement in the process; and – whether different processes should be used for different funds; and • adopt appropriate methods to assess risks, which may include: – self-assessment; – stress testing and/or scenario analysis; – loss data analysis; – change management; and – digital systems.	Fund operators may use risk indicators and regularly report on these to the board and senior management.

Section	Expectations for compliance with s912A(1)(h)	Good practice guidance (not mandatory)
Section D (Managing risks)	Fund operators should: • implement appropriate strategies for managing each of the material risks identified, including: – a control monitoring and assurance process; – conducting stress testing and/or scenario analysis of liquidity risks of the funds they operate as part of their risk management systems as frequently as appropriate, given the nature, scale and complexity of the business (at a minimum, annually); – reviewing their framework for stress testing and/or scenario analysis—to ensure the tested scenarios are relevant and appropriate in light of the business and market conditions—as frequently as appropriate, given the nature, scale and complexity of the business (at a minimum, annually); and – if stress testing and/or scenario analysis is not conducted, document why this is the case, keep appropriate internal records of this rationale and review this decision regularly; • have adequately experienced staff regularly review and monitor the risks identified; • ensure there is regular reporting and escalation of issues to the board, risk committee and compliance committee, as appropriate; and • ensure compliance with other relevant obligations as an AFS licensee.	Fund operators may: • conduct regular stress testing and/or scenario analysis of all material risks of the business and the funds they operate; • have a written risk treatment plan; and • include in the compliance plan for their funds additional procedures for ensuring that the material risks identified for the fund are relevant and managed on an ongoing basis.

RG 259.9 In the appendix to this guide we give examples of risks and risk treatments that we consider are particularly relevant to fund operators, based on our regulatory experience. These examples may help operators establish and review their arrangements to identify, assess and manage risks, and may be considered by operators as part of these processes.

RG 259.10 The examples of risks in this guide are not intended to be exhaustive. We expect that, through the application of a structured and systematic process, fund operators will identify, assess and manage risks relevant to their business and the funds they operate in an ongoing and dynamic way.

Who this guide applies to

RG 259.11 This guide is for responsible entities of registered schemes and corporate directors of CCIVs but is also relevant for:

(a) AFS licensees not currently operating a fund;

(b) investor directed portfolio services (IDPS) and managed discretionary account (MDA) operators; and

(c) entities operating unregistered managed investment schemes.

Other entities that may benefit from this guidance

RG 259.12 We expect all AFS licensees authorised to operate a fund to consider this guide, even if they are not currently operating any funds. This will help ensure they have in place compliant risk management systems that can be applied to the funds on commencement of their operation.

RG 259.13 We expect IDPS and MDA operators to consider this guidance when establishing and reviewing their risk management systems, as these services would need to be registered schemes if they could not rely on our relief for IDPSs and MDAs.

RG 259.14 All aspects of this guide may not be relevant to entities operating unregistered managed investment schemes. However, we recommend that operators of such schemes consider this guidance when establishing and reviewing their risk management systems.

B Establishing risk management systems

Key points

A fund operator should ensure its risk management systems comprise documented processes to identify, assess and treat risks, and that these systems are suitable for its business and the funds it operates: see RG 259.15–RG 259.16.

This section sets out our guidance for fund operators on:

- developing risk management systems (see RG 259.17–RG 259.25);
- implementing and reviewing risk management systems (see RG 259.26–RG 259.29);
- setting risk management in context (see RG 259.30–RG 259.31 and Table 2);
- risk appetite (see RG 259.32–RG 259.36);
- the role of culture and structure in risk management systems (see RG 259.37–RG 259.45);
- liquidity management (see RG 259.46–RG 259.49); and
- relevant industry, local and international guidance (see RG 259.50–RG 259.53).

This section also sets out our good practice guidance for establishing risk management systems: see RG 259.54–RG 259.62.

Risk management systems

RG 259.15 The international standard for risk management defines risk as the 'effect of uncertainty on objectives' and risk management as 'coordinated activities to direct and control an organization with regard to risk': see International Standard ISO 31000:2018 *Risk management—Guidelines*.

RG 259.16 Effective risk management needs to:

(a) be integrated;

(b) be structured and comprehensive;

(c) be customised;

(d) be inclusive;

(e) be dynamic;

(f) use the best available information;

(g) consider human and cultural factors; and

(h) have continual improvement.

Developing risk management systems

RG 259.17 Risk management systems include all structures, systems and subsystems, policies, procedures, and staff that a fund operator uses to identify, assess and treat risks or to monitor and review the relevant controls or measures. It may be regarded as a framework comprising all elements that allow the fund operator to perform its risk management functions as required by the Corporations Act.

RG 259.18 Adequate risk management systems enable material risks faced by the fund operator and the funds it operates to be identified, analysed and treated in a comprehensive and systematic way. Sound corporate governance and management oversight are an essential part of any effective risk management systems.

RG 259.19 The adequacy of a fund operator's risk management systems will depend on the nature, scale and complexity of its business and the funds it operates.

RG 259.20 We consider the following to be core processes that are essential to adequate risk management systems in any fund operator's business:

(a) setting out the scope, context and criteria in which the risk management systems operate, including a policy or statement on the fund operator's risk appetite (see RG 259.30–RG 259.36);

(b) identifying and assessing risks (see Section C); and

(c) managing risks, including reviewing and monitoring the risk management systems (see Section D and RG 259.26–RG 259.29).

RG 259.21 A fund operator should maintain documented risk management systems that include:

(a) clearly defined roles and responsibilities;

(b) policies and procedures for identifying, assessing and understanding each of the material risks of the fund operator's business and funds operated;

(c) policies and procedures for ensuring there are adequate controls in place to manage the risks identified;

(d) policies and procedures for ensuring there is adequate oversight of the risk management systems by both the party responsible for ownership of the risk and the compliance function, including appropriate reporting; and

(e) a policy or statement on the fund operator's risk appetite and the risk tolerance for each material risk identified.

RG 259.22 We expect fund operators to maintain a strong understanding of risk management in the context of the business, even if the establishment and the monitoring of the risk management systems are done by a small group of employees or external third-party service providers (e.g. compliance and risk management consultants). We expect those who carry out the risk management function to have appropriate knowledge and skills.

RG 259.23 Where external third-party service providers are used, we expect fund operators to have sufficient skills to independently identify material risks and to monitor and assess the service provider's performance and ongoing suitability. We note that responsible entities retain ultimate responsibility for the operation of a scheme (see s601FB) and corporate directors have responsibility for the operation of a CCIV (see s1224M).

RG 259.24 We understand that if a fund operator is part of a corporate group, the risk management systems of the fund operator, or the policies and procedures for its risk management systems, may be subject to the overarching approach of the corporate group or form part of its risk management framework. Some fund operators may rely on the risk management systems of a related entity to assist with complying with their risk management obligations.

RG 259.25 This may be appropriate for businesses that are part of a larger corporate group; however, if this approach is adopted, each fund operator should take into consideration their specific individual risks and requirements. The fund operator should carefully assess the risk management systems of the corporate group or related entity to ensure that they are appropriate and tailored as necessary.

Implementation and review of risk management systems

RG 259.26 Risk management systems are most effective if applied and adhered to in day-to-day decision making at all levels. Therefore, it is essential that a fund operator ensures that all processes, policies and procedures that form part of its risk management systems are implemented and applied to the day-to-day operation of its business and the funds it operates.

RG 259.27 We consider that the development of adequate risk management systems is not a 'set and forget' or one-off process. The systems should adapt and evolve to take into account internal changes within the fund operator and the funds it operates, as well as changes in the external environment.

RG 259.28 To ensure that risk management systems are always current, relevant, effective and complied with, they should be monitored and reviewed as frequently as appropriate, given the nature, scale and complexity of the business and the funds operated. This should be at least annually. See also RG 259.89–RG 259.90.

RG 259.29 We consider that the fund operator's senior management has a specific role in ensuring that:

(a) this review is undertaken;

(b) the risk management systems are current, relevant, effective and complied with on an ongoing basis; and

(c) the risk management systems remain appropriate to the business and funds operated.

Setting risk management in context

RG 259.30 A fund operator should consider and document the context in which its risk management systems are developed. That is, the internal and external environment in which its business operates, including the objectives of the business.

RG 259.31 Adequate risk management systems require a thorough understanding of the internal and external factors that could affect the fund operator's ability to achieve its goals and objectives. Table 2 lists some examples of these factors.

Table 2: Examples of internal and external factors

Internal factors	External factors
• Vision, missions, value, goals and objectives in the strategic and business plans, including the objectives of the relevant funds (e.g. whether a fund will be a liquid fund offering redemptions on demand or an illiquid fund). Particular business strategies may create specific risks affecting the business. • Capabilities of the organisation (e.g. financial, human and technological resources). • Information flow and decision-making processes. • Culture of the fund operator. • Interdependencies and interconnections.	• Business, financial, competitive, political, economic, social, cultural, technological and environmental factors the business faces. • Expectations of external stakeholders (including shareholders) about the operation of the business. • Legal and regulatory changes that affect the operation of the business and the funds. • New product offerings in the market that compel a fund operator to compete more effectively. • Contractual relationships and commitments. • The complexity of networks and dependencies.

Policy or statement on risk appetite

RG 259.32 A fund operator should document its risk appetite in a policy or statement. This policy or statement should outline the fund operator's attitude towards risk taking while carrying out its business plans, including the amount of risk (which may refer to the level of losses) it is willing to take to pursue its business strategies and achieve its objectives. It should also address the risks relevant to the fund operator's overall strategy to achieve its objectives and set out the limits to these risks. In undertaking this process we consider it is important for the fund operator to take into account any differences in the risk profile of the funds operated.

RG 259.33 The fund operator may have one such policy or statement setting out its risk appetite in aggregate, or separate policies and statements. The policy or statement should be approved by the board or its delegate.

RG 259.34 During this process the risk tolerance for each material risk should be identified. This can be expressed in qualitative or quantitative terms, where appropriate. The risk tolerance will reflect the risk appetite.

RG 259.35 A fund operator should ensure its risk appetite is reviewed at appropriate intervals and that it takes into account changes in the internal and external context in which the business operates, including changes to the objectives and strategic direction of the business.

RG 259.36 Fund operators may adopt the following approach in setting and applying a policy or statement on risk appetite:

(a) senior management sets the policy or statement on risk appetite for the business;

(b) the board or its delegate approves the policy or statement on risk appetite;

(c) based on this statement, risk tolerance is set and documented for each material risk, broken down into clearly defined limits or thresholds for particular activities of the business to support the decision-making process; and

(d) risk management processes, policies and procedures to implement and monitor the limits and thresholds are developed and communicated to staff, so that they are applied to support day-to-day operational decision making.

Risk management culture

RG 259.37 We expect fund operators to foster a strong risk management culture throughout their organisations. The effectiveness of adequate risk management systems depend on the whole organisation understanding the value of managing risks effectively, and acting accordingly.

RG 259.38 We expect fund operators to ensure that all relevant staff understand the purposes of risk management, including ensuring legal and regulatory compliance, as well as its value to the organisation. This can be done through induction, training and education programs.

RG 259.39 The board and senior management have specific responsibilities to ensure that a fund operator, as an AFS licensee, complies with its obligation to have adequate risk management systems. We acknowledge that the board may not be directly involved in the day-to-day operation of the policies, procedures and processes for the risk management systems and may delegate the supervision of these roles. However, the board's commitment to fostering a strong risk management culture within the organisation is especially important, as the board is in a position to provide leadership and make sure that relevant measures are implemented effectively.

RG 259.40 An effective risk management culture may include:

(a) communicating with staff about the importance of managing risks to achieve strategic business objectives;

(b) providing sufficient resources for all risk management functions;

(c) relevant staff receiving ongoing training about risk management (e.g. general risk management training and/or training that is relevant to a staff member's role and responsibilities) to help them identify risks and understand how they can be managed;

(d) discouraging breaches of any risk management procedures by staff through adequate consequence management;

(e) supporting, recognising and/or rewarding employees who demonstrate their commitment to effective risk management; and

(f) assigning a designated director the responsibility of making sure the risk management systems for the fund operator and funds it operates are adequate (or designated directors having responsibility over particular parts of the risk management system).

RG 259.41 We expect fund operators to implement and maintain remuneration policies that are aligned with, and supportive of, the risk management systems of their business, including the funds they operate.

Structure and risk ownership

RG 259.42 A fund operator's risk management systems should include details of the functions, roles and responsibilities for implementing and carrying out specific risk management activities.

RG 259.43 We consider that an adequate risk structure requires:

(a) staff who perform risk management functions to have the appropriate knowledge and skills;

(b) decision making that is cognisant of the risk management systems;

(c) key staff to take responsibility for owning risks and developing processes to mitigate them;

(d) regular reviews; and

(e) that risk owners regularly monitor and report on those risks.

RG 259.44 We expect fund operators' risk management systems to require relevant staff to report internally to identified escalation points (e.g. the risk management committee, the designated risk management function or the board) about compliance with risk management processes, policies and procedures on a regular basis, and whenever any issues are identified (e.g. exceeding the risk tolerance for a particular risk, or a failure to follow the relevant processes). Such reporting increases the risk-related information available in the organisation, to assist decision making and improve risk management systems where systemic issues about their operation are identified.

RG 259.45 We also consider that fund operators should implement processes for regular reporting and escalation of issues to the board and/or any risk or compliance committee established.

Liquidity risk management

RG 259.46 Effective liquidity risk management is important for a fund operator to ensure the financial obligations and needs of the business and funds operated are met, including:

(a) investor redemptions;

(b) payment of distributions;

(c) changes in operational needs; and

(d) unexpected expenses.

RG 259.47 We expect risk management systems of fund operators to include a liquidity risk management process, designed to ensure there are adequate financial resources to meet the financial obligations and needs of the fund operator and the funds operated.

RG 259.48 At the fund level, we expect this will include stress testing or scenario analysis (see RG 259.91–RG 259.98). We also expect it will include fund operators assessing available liquidity management tools and considering whether these are appropriate to use. For example, redemption fees, suspension of withdrawal requests, redemption gates (a limit on the amount of redemptions), *in specie* transfers (transferring assets of an equivalent amount instead of providing cash proceeds), swing pricing (applying higher transaction costs adjustments on redemptions, reflecting the lack of an offsetting issue of fund interests or shares), minimum or maximum limits on withdrawals, or satisfying withdrawals on a partial or staggered basis.

RG 259.49 At the fund operator level, we expect this will include an ongoing assessment of whether the fund operator is complying with the financial requirements of its AFS licence and is able to meet its financial obligations and needs.

Relevant industry, local and international guidance

RG 259.50 In developing, implementing and reviewing its risk management systems, we consider that a fund operator should take into account relevant industry, local and international guidance.

RG 259.51 We appreciate that in many cases compliance with the guidance may not be mandatory and a wide range of material may exist. We expect, at a minimum, that fund operators will consider whether the guidance that exists for the material risks identified for the business and funds operated would be useful to adopt.

RG 259.52 We consider liquidity a material risk for funds. In developing their liquidity risk management process, fund operators should consider the following international guidance, which outline tools to help fund operators manage liquidity risk:

(a) the International Organization of Securities Commissions' (IOSCO) Recommendations for Liquidity Risk Management for Collective Investment Schemes; and

Note: See IOSCO, *Recommendations for liquidity risk management for collective investment schemes: Final report* (PDF 363 KB), February 2018.

(b) the Financial Stability Board's (FSB) Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities.

Note: See FSB, *Policy recommendations to address structural vulnerabilities from asset management activities*, January 2017.

RG 259.53 We encourage industry bodies and associations to develop standards on risk management, to further assist fund operators to meet their obligation under s912A(1)(h).

Good practice guidance

RG 259.54 Additional strategies that may be implemented by fund operators in establishing and maintaining risk management systems include:

(a) supplementary review of the risk management systems (see RG 259.55–RG 259.56);

(b) segregating functions to allow for independent checks and balances (see RG 259.57);

(c) designating a risk management function and committee (see RG 259.58–RG 259.60);

(d) appointing a chief risk officer (see RG 259.61); and

(e) publicly disclosing a summary of key aspects of their risk management systems (see RG 259.62).

Review of risk management systems

RG 259.55 Fund operators may undertake an additional independent comprehensive review of the appropriateness, effectiveness and adequacy of the risk management systems (at least every three years).

RG 259.56 The above review should be carried out by an independent, appropriately trained and competent person. This does not require an external party and can be done internally, as long as the fund operator is satisfied that any other roles carried out by the person reviewing the risk management systems do not have an impact on their ability to perform an objective review and will not limit the robustness of the review.

Segregation of functions to allow for independent checks and balances

RG 259.57 Depending on the nature, scale and complexity of the business, we encourage fund operators to segregate functions to allow for independent checks and balances. This may include, for example, segregating the internal function in charge of valuing assets from the investment management function. We consider this will help manage conflicts of interests that may arise, and builds in an additional level of oversight to identify any issues.

Designated risk management function and committee

RG 259.58 Depending on the nature, scale and complexity of the business, we consider it is good practice for fund operators to establish a designated risk management function and/or risk management committee. We understand that this may not be feasible for some operators.

RG 259.59 The designated risk management function may have a hands-on role in ensuring the day-to-day operation of a fund operator (including the funds it operates) is conducted in alignment with its risk management systems. To achieve this, the designated risk management function may be independent from the operating units of the fund operator's business. It may also have the specific responsibility of monitoring compliance with risk management processes, policies and procedures, as well as reporting to the board and any risk management committee all significant breaches of the processes, policies and procedures.

RG 259.60 The responsibilities of a risk management committee may include:

(a) helping senior management develop the risk management systems;

(b) reviewing the effectiveness of the risk management systems;

(c) reporting to the board and/or senior management on breaches of risk tolerance or risk management processes, policies and procedures, according to the fund operator's escalation policy; and

(d) reporting to the board and/or senior management on the risk management systems and their performance.

Appointing a chief risk officer

RG 259.61 Depending on the nature, scale and complexity of the business, we consider it is good practice for fund operators to appoint a dedicated chief risk officer. Generally, the chief risk officer will be a key member of senior management to ensure they have sufficient stature and authority to influence risk-based decision making. It is important for any chief risk officer to communicate freely and have direct and unfettered access to the board, senior management and any risk or compliance committee established.

Disclosure of risk management policies

RG 259.62 In addition to its obligation to disclose information about significant risks in the Product Disclosure Statement (PDS) under Pt 7.9 of the Corporations Act, an issuer may provide additional transparency to investors about its arrangements by publicly disclosing a summary of the key aspects of the risk management systems of the fund operator—for example, on its website or in its annual report.

C Identifying and assessing risks

Key points

This section sets out our guidance for fund operators on identifying and assessing risks, including:

- the processes for identifying risks, documenting the processes, policies and procedures used to identify these risks, and maintaining one or more risk registers to record material risks (see RG 259.64–RG 259.68). The processes should be suitable for the business's objectives and operations, including for the funds it operates;
- ensuring their risk management systems address all material risks (see RG 259.69–RG 259.70) for their business and each fund operated. These may include strategic risk, governance risk, operational risk, market and investment risk, and liquidity risk;
- strategies for assessing identified risks and documenting its risk assessment processes (see RG 259.71–RG 259.75); and
- taking into account certain factors when selecting risk identification and assessment methodologies (see RG 259.76).

It also sets out our good practice guidance for identifying and assessing risks: see RG 259.77.

Identifying risks

RG 259.63 Risk identification is the process used by fund operators to identify risks that will affect their ability to pursue business strategies and achieve the objectives of their business.

RG 259.64 We do not consider that any one particular method for identifying risks is the most appropriate and applicable for all fund operators.

RG 259.65 Fund operators should adapt the processes for risk identification in their risk management systems as the business develops and business risk profiles change, over time and in different market conditions. Risks need to be identified at any given point in time to ensure fund operators can effectively manage them in the operation of their business and day-to-day decision making.

RG 259.66 There are different ways to identify the risks that can affect a fund operator's business. For example, evidence-based methods that rely on reviewing audit reports, post-event reports, historical data or risk registers can help to identify existing and emerging risks that the fund operator may face. Observations from our regulatory experience indicate that incorporating this approach to risk identification in strategic and business planning is particularly helpful in identifying risks. Fund operators may use a systematic team approach that uses focus groups and brainstorming to identify risks. Purpose-built software can also be used.

RG 259.67 A fund operator should document the processes, policies and procedures it uses to identify risks.

RG 259.68 We expect fund operators to maintain one or more risk registers for recording material risks to the business and funds operated as part of their risk identification process. A fund operator should select the format of the risk register(s) that is most suitable for the business and funds operated. Fund operators are not required to keep separate risk registers at the fund operator and fund level, or for each fund they operate, as long as the material risks for the business and each fund operated are identified and addressed in the registers maintained.

Risks relevant to the business and the funds

RG 259.69 We appreciate that the risks identified by fund operators as part of their risk management systems will depend on the nature, scale and complexity of their business and risk profile, and will be different for each fund operator. Our regulatory experience suggests that certain types of funds (e.g. unlisted property funds, mortgage funds, agribusiness funds, quoted funds, hedge funds and novel funds) are subject to more complex risks.

RG 259.70 A fund operator should ensure that its risk management systems address all the material risks faced by the business and each fund operated. These may include, but are not limited, to the following risks:

(a) *Strategic risk*—Any risk that arises out of a fund operator's business strategies and business plan.

(b) *Governance risk*—Any risk that threatens the ability of a fund operator to make reasonable and impartial business decisions in the best interests of members. This risk may arise if a fund operator does not have the appropriate processes in place to:

(i) support sound and transparent decision making that is not influenced by conflicts of interests; and

(ii) ensure that decisions related to the funds are in the best interest of members.

(c) *Operational risk*—The risk of loss, for the business or funds, resulting from inadequate or failed internal processes, people and systems or from external events.

(d) *Market and investment risk*—The risk that a fund operated by a fund operator will not meet its objectives. Specific investment risks include those relating to investment governance and structure, market conditions, counterparty failure, product suitability, and valuation and pricing.

(e) *Liquidity risk*—The risk that the fund operator will not have adequate financial resources to meet its financial obligations and needs, either at the fund operator level or at the fund level (including meeting the fund's objectives and members' expectations for redemptions). As previously outlined, we consider that liquidity risk is a material risk for funds.

Note: For a detailed description of these risks (including examples of specific risks) and treatments to manage these risks based on our regulatory experience, see the appendix to this guide.

Strategies for assessing risks

RG 259.71 Risk assessment is the process of describing identified risks, including by reference to the inherent risk, and determining the likelihood of a risk eventuating and the significance of its potential impact. This process can help a fund operator determine whether the identified risks are acceptable in light of its risk appetite and develop appropriate treatments for those risks.

RG 259.72 Examples of different methods that fund operators may adopt for assessing risks include the following:

(a) *Self-assessment*—The fund operator, its senior management and those in the designated risk management function (if applicable) assess risks through the business and the funds it operates. This may include risk mapping, where risks are prioritised according to the significance of the risk and likelihood of a risk eventuating and mapped into four quadrants.

(b) *Stress testing and/or scenario analysis*—The fund operator uses techniques such as stress testing and/or scenario testing to assess how it will be impacted by different scenarios. See also RG 259.91–RG 259.98.

(c) *Loss data analysis*—The fund operator implements processes to analyse observed incidents to evaluate the actual losses caused by risks.

(d) *Change management*—The fund operator implements processes to assess how the business and funds operated are affected by change, to ensure objectives are still met.

(e) *Digital systems*—The fund operator uses purpose-built software to assess risks.

RG 259.73 Fund operators may also seek expert advice and appoint an external consultant to help in the process of assessing the likelihood of a risk eventuating and the significance of its potential impact.

RG 259.74 We do not consider that any one particular approach for assessing risks will be the most appropriate and applicable to the operation of all fund operators.

RG 259.75 A fund operator should document its risk assessment processes. Documenting the reasons why particular assessments are made, including the thinking that led to the decisions about identified risks, provides a useful context for future risk assessment.

Selecting risk identification and assessment methodologies

RG 259.76 When considering which approach or combination of approaches to adopt in identifying and assessing risks, fund operators may consider:

(a) the nature, scale and complexity of the business;

(b) incidents and complaints, trends or developments in the industry, and changes to the business environment;

(c) processes based on a forward-looking analysis in accordance with strategic and business plans (e.g. when assessing the risk of not having adequate technological or human resources, identification of risks should be based on forward planning);

(d) the need to ensure there is an appropriate level of human input in the process—sole or disproportionate reliance on digital systems may not be adequate;

(e) senior management involvement in the process (e.g. any determination about whether an identified risk is at an acceptable level in light of the policy or statement on risk appetite); and

(f) if applicable, whether different processes should be used to identify and assess risks for different funds in light of the operation of each particular fund.

Good practice guidance

RG 259.77 Fund operators may use risk indicators to provide an early signal of increasing risk exposures in various areas of the business. Regular reporting on the risk indicators can give the board and senior management an insight into the changes in the external and internal environment that may indicate risk concerns. It can also help ensure that risk levels are managed within defined tolerances.

D Managing risks

Key points

This section sets out our guidance for fund operators on managing risks, including:

- determining appropriate risk treatments (see RG 259.78–RG 259.80);
- controls or measures to manage or mitigate risk (see RG 259.81–RG 259.83;
- use of technology (see RG 259.84);
- compliance with other relevant obligations as an AFS licensee (see RG 259.85 and Table 3);
- dealing with residual risks (see RG 259.86);
- monitoring and review (see RG 259.87–RG 259.90); and
- stress testing and scenario analysis (see RG 259.91–RG 259.98).

It also sets out our good practice guidance for managing risks: see RG 259.99–RG 259.102.

Determining appropriate risk treatments

RG 259.78 A fund operator should determine the appropriate treatment for each material risk identified and document how the risk will be treated.

RG 259.79 There are different ways that fund operators may manage risks. For example, they may:

(a) do nothing if the identified risk is within acceptable risk tolerance levels;

(b) avoid the risk by not undertaking the relevant activities that give rise to the risk;

(c) prevent the eventuation of the risk through specific actions, such as developing rules and documented policies and procedures;

(d) reduce or mitigate the consequences or impact of realised risks (e.g. through contingency, emergency or business continuity plans); and/or

(e) transfer the risks to other parties, through insurance, outsourcing or indemnification.

RG 259.80 Risks faced by the business should be considered as a whole, given that some risks may be interrelated (e.g. liquidity and valuation risks).

Controls or measures to manage or mitigate risks

RG 259.81 We expect fund operators to have adequate controls to manage or mitigate risks (e.g. performance standards for external service providers). It is also important for the fund operator to implement a control monitoring and assurance process that considers the:

(a) adequacy of coverage of controls and whether appropriate remediation and response strategies are in place for material risks;

(b) effectiveness of internal controls designed to ensure risks have been mitigated; and

(c) appropriateness of monitoring strategies and ongoing testing (e.g. self-assessment, real-time transaction monitoring and reporting, and control assurance reviews by independent teams).

RG 259.82 The appendix to this guide includes examples of controls and measures for treating the risks that we consider are most relevant to the business of a fund operator. The examples of risk treatments in the appendix are not mandatory, unless otherwise specified in the guidance.

RG 259.83 Nor are the risk management strategies exhaustive. We expect fund operators to implement strategies for managing risks that are appropriate to the nature, scale and complexity of the business and funds operated.

Use of technology

RG 259.84 There are a variety of technological resources that can be used to help fund operators manage risks. These technologies come in a variety of forms and can help by analysing and storing data, automating compliance processes, monitoring trading, and streamlining regulatory reporting. External service providers may be used to facilitate this process and also to store data. The use of these technologies may result in enhanced and more cost-effective management of risks. However, it is important to ensure that there is appropriate human oversight and review of any technological resources used.

Compliance with other relevant obligations as an AFS licensee

RG 259.85 Apart from the obligations contained within s912A(1)(h), we expect fund operators to comply with their other existing obligations as an AFS licensee. As outlined in Table 3, many of these obligations are also relevant to assisting the management of risks.

Table 3: Other relevant AFS licence obligations

Obligation	Explanation	Further guidance
Compensation for retail clients: s912B	If financial services are provided to retail clients, an AFS licensee must have arrangements for compensating those persons for loss or damage suffered due to breaches by the licensee or its representatives. We consider adequate professional indemnity (PI) insurance is another important measure to manage operational risk.	Regulatory Guide 126 *Compensation and insurance arrangements for AFS licensees* (RG 126)
Adequate financial resources: s912A(1)(d)	An AFS licensee must have adequate financial resources. All fund operators must comply with minimum financial requirements. We consider these requirements are another important measure to assist in managing liquidity risk affecting the fund operator itself. We expect operators to ensure that their financial resources will be adequate to carry on their business in compliance with their licensee obligations, or to wind up their business in an orderly manner.	Regulatory Guide 166 *AFS licensing: Financial requirements* (RG 166), Class Order [CO 13/760] *Financial requirements for responsible entities and operators of investor directed portfolio services* and *ASIC Corporations (Financial Requirements for Corporate Directors of Retail Corporate Collective Investment Vehicles) Instrument 2022/449*.
Adequate records of scheme operation: s601HA(1)(e)	The compliance plan of a registered scheme must set out the arrangements for ensuring adequate records of the scheme's operations are kept. In complying with this obligation, we expect that a responsible entity will ensure that it keeps adequate records of the establishment, implementation and review of its risk management systems for the schemes operated. The compliance plan of a CCIV must set out adequate measures that the corporate director will apply when fulfilling its responsibilities in relation to the CCIV to ensure compliance with the Corporations Act and the CCIV's constitution: see s1226A.	Regulatory Guide 132 *Funds management: Compliance and oversight* (RG 132)
Adequate technological resources: s912A(1)(d)	An AFS licensee must have adequate technological resources. We expect that in complying with this obligation a fund operator will maintain secure and stable information systems. This will assist in managing relevant risks, including system failure and malicious cyber activity.	Report 429 *Cyber resilience: Health check* (REP 429)

Obligation	Explanation	Further guidance
Reportable situations: s912DAA	An AFS licensee must report to ASIC, in writing, all reportable situations within 30 calendar days after the licensee first knows that there are reasonable grounds to believe a reportable situation has arisen. We expect that a fund operator will ensure that it reports any breach of s912A(1)(h). We consider processes to identify, escalate, report and analyse breaches (including trends) can help manage risks.	Regulatory Guide 78 *Breach reporting by AFS licensees and credit licensees* (RG 78)

Residual risks

RG 259.86 Residual risks often remain, even after measures to treat risks have been applied. Understanding the concept of residual risk is an important consideration when identifying, assessing and managing risks, as it determines whether residual risks are within acceptable risk tolerance levels or require further treatment. It can also help inform future risk assessments. Monitoring residual risks can help ensure they do not increase to a level above the fund operator's risk appetite, and determine whether further treatment should be applied to manage those risks.

Monitoring and review

RG 259.87 A fund operator should ensure that staff members follow the processes, policies and procedures put in place to manage risks.

RG 259.88 We expect fund operators to have adequately experienced staff who regularly review and monitor the risks identified. We also expect operators to ensure there is regular reporting and escalation of issues to the board, risk committee and compliance committee, as appropriate.

RG 259.89 As previously outlined, we consider that a fund operator should review and monitor its risk management systems as frequently as appropriate—given the nature, scale and complexity of the business and funds operated—to ensure they are current, relevant, effective and complied with. We expect this to be done at least on an annual basis. The nature, scale and complexity of the business and the funds operated will also determine the level of detail of the review. If the review is undertaken internally, a fund operator should consider appropriate steps to ensure that the review is objective.

RG 259.90 Such reviews may:

(a) comprehensively cover all aspects of the fund operator's risk management systems, including the policy and statement on risk appetite and all processes, policies and procedures related to these systems;

(b) take into account changes affecting the fund operator's business and the funds it operates, including changes to:

  (i) the operation of the fund operator or its funds;

  (ii) the context in which the fund operator operates the business or funds;

  (iii) the fund operator's risk appetite or strategic business objectives;

  (iv) laws that affect the business or funds; and

  (v) business plan objectives, including starting any new business;

(c) monitor compliance with the risk management systems, including the processes, policies and procedures put in place to identify, assess and manage risks;

(d) ensure information systems are effective and up to date;

(e) ensure escalation policies and procedures are operating and effective; and

(f) ensure reporting of breaches is occurring, document the review process and any issues identified, and report to the board or senior management.

Stress testing and scenario analysis

RG 259.91 We expect a fund operator to conduct stress testing and/or scenario analysis of the liquidity risks identified for the funds it operates as frequently as appropriate—given the nature, scale and complexity of the business—and to update or revise its arrangements if required in response to the testing or analysis results. At a minimum, we expect this to be undertaken annually. We consider liquidity risk a material risk for which fund operators should undertake stress testing and/or scenario analysis.

RG 259.92 We also expect fund operators to review their framework for stress testing and scenario analysis as frequently as appropriate—given the nature, scale and complexity of the business—to ensure the nature, currency and severity of the tested scenarios are relevant and appropriate, in light of the business and market conditions. At a minimum, we expect this to be undertaken annually.

RG 259.93 If a fund operator does not conduct stress testing or scenario analysis we expect it to document why this is the case, and to review this decision regularly.

RG 259.94 While terminology varies, stress testing and scenario analysis are generally used to assess how a fund operator or a fund will be affected and respond in different extreme scenarios. This is essentially a ‘what if’ exercise that examines what may happen if certain risks materialise. Developing well-targeted, plausible and sufficiently adverse scenarios is a critical part of effective stress testing.

RG 259.95 There is no common methodology for stress testing or scenario analysis; however, these need to be tailored to the fund operator and the funds it operates. Understanding the interdependence of certain risks is important.

RG 259.96 The testing and analysis can include short-term and prolonged adverse environmental impacts, and take into account entity-specific and market-wide ‘shocks’. For example:

(a) the impact of significant market movements;

(b) liquid assets becoming illiquid;

(c) significant regulatory change;

(d) a requirement to repay finance if a debt rollover or an extension cannot be arranged;

(e) significant reductions in net cash inflows through reduced applications or increased redemption requests; or

(f) significant asset revaluations.

RG 259.97 The results of any stress testing or scenario analysis will inform future risk identification, assessment, evaluation and management. A range of approaches may be useful, such as:

(a) sensitivity analysis;

(b) stress testing based on experience or historical events;

(c) reverse stress testing designed to identify a stress scenario that would cause failure;

(d) longer term scenarios (e.g. prolonged low interest rate environment) and short-term scenarios (e.g. natural disasters); or

(e) a combination of scenarios (e.g. a series of less significant events occurring within a short timeframe).

RG 259.98 Stress testing can be used for different objectives, including:

(a) stress testing as an internal risk management tool;

(b) supervisory stress testing as an assessment tool;

(c) surveillance stress testing to identify sources of systemic risk or crisis management; and

(d) stress testing for business restructuring plans.

Note: For further details, see International Monetary Fund, *Macrofinancial stress testing—Principles and practices* (PDF 1.18 MB), August 2012 and the IOSCO Recommendations for Liquidity Risk Management for Collective Investment Schemes.

Good practice guidance

RG 259.99 Additional strategies that may be implemented by fund operators to manage risks include:

(a) stress testing and/or scenario analysis of all material risks identified for the fund operator's business and the funds it operates (see RG 259.100);

(b) risk treatment plans (see RG 259.101); and

(c) compliance plan procedures (see RG 259.102).

Stress testing and/or scenario analysis of all material risks

RG 259.100 Depending on the nature, scale and complexity of the business and funds operated, we consider that stress testing and/or scenario analysis of all material risks to a fund operator's business and the funds it operates is good practice. A key risk area for testing and analysis is market and investment risk.

Risk treatment plan

RG 259.101 We consider it good practice for fund operators, when documenting how they propose to treat risks, to maintain a plan that includes the following information about each identified risk:

(a) details of the risk;

(b) details of the proposed measures to treat the risk and the expected benefits of each measure;

(c) the approval process for implementing the measures;

(d) how implementation of the measures will be monitored and reviewed, including timing, who is responsible, resource requirements and contingencies, and any performance measures aligned with the implementation;

(e) the order in which the implementation of each measure is prioritised; and

(f) whether residual risk exists after the measures have been implemented, and whether such risk falls within acceptable risk tolerance levels.

Compliance plan procedures

RG 259.102 We also consider it good practice for the compliance plan of the fund to include procedures for ensuring that the material risks identified for the fund are relevant and managed. This is in addition to the existing content obligations under s601HA, and these procedures may be included as an appendix to the compliance plan. For existing funds, this may be considered as part of any broader review or update of the compliance plan by the fund operator.

Appendix: Examples of risks and risk treatments

RG 259.103 This appendix lists the risks that we consider most relevant to fund operators and the funds they manage:

(a) strategic risk (see RG 259.105–RG 259.109);

(b) governance risk (see RG 259.110–RG 259.112);

(c) operational risk (see RG 259.113–RG 259.132);

(d) market and investment risk (see RG 259.133–RG 259.146); and

(e) liquidity risk (see RG 259.147–RG 259.155).

RG 259.104 It gives examples of these risks, including specific risks under each category and examples of measures that responsible entities or corporate directors may consider in treating these risks. The examples are not intended to be exhaustive; they reflect common risks and measures we have observed through our regulatory experience. The examples of risks treatments are not mandatory, unless otherwise specified in the guidance.

Strategic risk

RG 259.105 Strategic risk is any risk that arises from a fund operator's strategic and business plans.

RG 259.106 Market conditions (e.g. instability or volatility) and market sentiment (e.g. uncertainty) can lead to cost pressures and reductions in cash flow for many fund operators. This raises risks to the operating model of some operators and may endanger the continuity of particular entities and funds.

RG 259.107 Developments of new products and systems or changes of strategic direction are examples of strategic risk.

RG 259.108 Changes in the external environment (e.g. the introduction of new financial requirements or tax changes) may affect an entity's business strategies or the investment strategy of the funds it operates.

RG 259.109 Similarly, consolidation through merger and acquisition activity can raise the risk of unsatisfactory business integration for the merging entities. If the consolidation is not managed appropriately, it could undermine each of the relevant businesses' risk management systems and lead to practical implementation issues, especially if full integration and consolidation may take long periods of time to complete.

Examples of risk treatments

Fund operators can treat this risk by:

- engaging in regular 'horizon scanning';
- engaging with regulatory bodies;
- engaging with industry bodies and peers; and
- stress testing key assumptions or factors that underpin the business model.

For mergers and acquisitions, fund operators can implement policies and procedures that ensure consideration is given to:

- the alignment of systems, processes, policies and procedures, and cultures before business integration; and
- appropriate resources and attention for effective implementation under direct supervision of the board during and after business integration.

Governance risk

RG 259.110 Governance risk is any risk that threatens the ability of a fund operator to make reasonable and impartial business decisions in the best interests of members.

RG 259.111 This risk arises if a fund operator does not have appropriate processes in place to support sound and transparent decision making that is in the best interests of members and is not adversely influenced by conflicts of interests.

RG 259.112 When considering whether to enter into a transaction with a related party, the interests of the related party may influence the entity's decision making to the detriment of fund members' interests or the fund as a whole.

Note: See also Regulatory Guide 76 *Related party transactions* (RG 76).

Examples of risk treatments

Fund operators can treat this risk by:

- having policies and procedures that guide decision making, including specifying who has the authority to make material decisions;
- certifying compliance regularly;
- implementing policies and procedures that ensure compliance with laws concerning related party transactions;
- getting independent advice on related party transactions;
- obtaining member approval for related party transactions;
- appointing independent directors;
- maintaining a diverse board; and
- publicly disclosing a summary of the key aspects of its risk management systems.

Operational risk

RG 259.113 Operational risk is the risk of loss, for the business or funds, resulting from inadequate or failed internal processes, people and systems, or from external events: see RG 259.116–RG 259.117.

RG 259.114 Specific operational risks include those relating to:

(a) legal and compliance requirements (see RG 259.118);

(b) technological resources (see RG 259.119–RG 259.120);

(c) human resources, including key persons (see RG 259.121–RG 259.122);

(d) outsourcing (see RG 259.123–RG 259.124);

(e) transitioning of the business (see RG 259.125);

(f) malicious cyber activity and ensuring cyber resilience (see RG 259.126–RG 259.127);

(g) any conduct of employees not aligned with the interests or the obligations of the fund operator (see RG 259.128); and

(h) fraud (see RG 259.129–RG 259.132).

RG 259.115 Operational risk is relevant to both the fund operator's business and the funds it operates.

Overview of operational risk

RG 259.116 Operational risk includes the risk of a fund operator having insufficient capacity and/or competence to conduct its financial services business and carry out supervisory arrangements in the best interests of fund members (e.g. the risk of inadequate financial, technological and human resources).

Note: An AFS licensee must have available adequate resources—including financial, technological and human resources—to provide the financial services covered by its licence and to carry out supervisory arrangements: s912A(1)(d).

RG 259.117 The factors influencing this risk are often dynamic and evolving, and need to be monitored closely.

Examples of risk treatments

Fund operators can treat this risk by:

- ensuring material aspects of operational procedures are documented and training is provided;
- periodically testing compliance procedures;
- auditing compliance with policies and processes;
- ensuring adequate insurance arrangements are in place; and

- in areas where potential conflicts could arise (e.g. valuation, risk management, compliance), segregating these activities from the investment management function with separate reporting lines.

Legal and compliance requirements

RG 259.118 There is a risk that a fund operator may not comply with financial services laws in conducting its financial services business, or be able to enforce certain legal rights that affect its business or the operation of its registered funds under particular circumstances (e.g. if it is cost prohibitive to enforce those rights). Alternatively, a fund operator may be the subject of legal action (e.g. a case in contract or tort law) or placed under external administration.

Examples of risk treatments

Fund operators can treat this risk by:

- documenting compliance plans and arrangements for the fund operator and the funds it operates;
- having breach registers and breach notification protocols;
- arranging for ready access to legal advice, whether internal or external; and
- ensuring timely breach reporting to regulators.

Technological resources

RG 259.119 There is a risk that the fund operator will not have adequate technological resources to conduct its business. This may include a lack of technological resources to recover from disasters or other major disruptions within a reasonable period. This risk may be higher for smaller fund operators (due to resource constraints) or where the business is heavily reliant on technological resources. There may also be difficulties in assessing the adequacy of technological resources where the fund operator is part of a corporate group that shares resources.

RG 259.120 Some fund operators may use resources such as software integration tools, real-time and system-embedded compliance evaluation tools, and cloud-based technologies as part of their compliance and data storage arrangements.

Examples of risk treatments

Fund operators can treat this risk by:

- implementing disaster recovery and business continuity plans; and
- systematically assessing the adequacy of technological resources, including where the entity forms part of a corporate group and shares resources.

Human resources (including key persons)

RG 259.121 There is a risk that the fund operator will not have adequate human resources or competence to conduct its financial services business. This risk may arise as a result of resource constraints, a lack of training or an excessive reliance on a small number of key staff.

RG 259.122 Key person risk is often inherent in smaller fund operators where there is a reliance on the skills and experience of one or two people who are crucial to its operations. The dominance of such key persons can unduly influence a business's culture and may lead to operational decisions being made that would not be considered appropriate within the fund operator's risk management systems.

Examples of risk treatments

Fund operators can treat this risk by:

- implementing succession planning to address key person risk;
- training staff to promote competence in the provision of financial services;
- auditing staff skills;
- having effective recruitment policies;
- regularly reviewing resource requirements, particularly during periods of growth or change;
- appointing independent directors; and
- maintaining a diverse board.

Outsourcing

RG 259.123 Some fund operators outsource functions instead of having the required technological or human resources in-house.

RG 259.124 The risk involved with outsourcing can be exacerbated when there is inadequate supervision of these functions, particularly where these functions are outsourced internationally. Failing to adequately supervise outsourced functions can have significant detrimental effects on the reputation of a business. The more critical the outsourced function, the greater the risks involved.

Examples of risk treatments

Fund operators can treat this risk by:

- implementing effective and comprehensive due diligence processes for choosing suitable service providers;
- having service level agreements;
- monitoring processes to address the ongoing performance of service providers;

- maintaining adequate staff and skill sets in-house to effectively monitor external service providers;
- having mechanisms for dealing appropriately and swiftly with any actions by service providers that breach service level agreements; and
- having policies and procedures to ensure agreements are always formalised and documented.

Transitioning of the business

RG 259.125 A risk may arise if a fund operator is unable to conduct its business due to a lack of adequate planning and preparation to facilitate the transitioning of the business, resulting in unnecessary loss. Examples include:

(a) appointment of a receiver over assets of the fund (if a fund operator becomes subject to external administration); or

(b) a change of fund operator for the fund.

Examples of risk treatments

Fund operators can treat this risk by implementing:

- business continuity plans;
- transition plans to facilitate an orderly transfer of the fund operator's business in stressed conditions;
- succession planning; and
- policies to ensure clear records identifying fund assets are maintained.

Malicious cyber activity and ensuring cyber resilience

RG 259.126 There is a high risk that a fund operator may be subject to malicious cyber activity, which is an attempted or actual incident that either:

(a) uses computer technology or networks to commit or facilitate the commission of traditional crimes, such as fraud and forgery—for example, identity or data theft (computer assisted); or

(b) is directed at computers and computer systems or other information communication technologies.

RG 259.127 Cyber resilience is the ability to prepare for, respond to and recover from malicious cyber activity. Resilience is more than just preventing or responding to an attack—it also takes into account the ability to adapt and recover from such an event.

Examples of risk treatments

Fund operators can treat this risk by:

- conducting regular cyber resilience health checks. For additional guidance, see REP 429;

- updating policies and procedures to reflect current industry and international guidance;
- regularly testing information technology (IT) systems;
- implementing disaster recovery and business continuity plans; and
- regularly reviewing the material risks they bear from and pose to other entities as a result of technology interdependencies.

Employee misconduct

RG 259.128 This is the risk of the conduct of employees (deliberately or inadvertently) not being aligned with the interests or obligations of the fund operator. For example, employees providing inappropriate advice, causing loss to investors and the fund operator or funds (including reputational damage), or both.

Examples of risk treatments

Fund operators can treat this risk by:

- carrying out comprehensive employment screening;
- implementing a conflicts of interest policy;
- adequately training employees regarding the conflicts of interest policy;
- having appropriate remuneration systems that support risk management and do not create incentives for employee misconduct;
- monitoring employee conduct through, for example, exceptional reporting of unusual events and random review or audit of transaction records;
- maintaining an internal audit function;
- conducting peer reviews;
- having whistleblower policies and procedures;
- digitally monitoring high-risk functions; and
- implementing other controls to prevent misappropriation of client funds, such as co-signing policies.

Fraud risk

RG 259.129 Fraud is dishonest activity causing actual or potential financial loss, including theft of money or other property by employees or persons external to the entity.

RG 259.130 Fraud risk also includes the deliberate creation, concealment, destruction or use of falsified documentation or the improper use of information or position for personal financial benefit. It includes:

(a) bribery and corruption—for example, the acceptance of bribes in exchange for assisting with a fraudulent transaction, such as false investment instructions to a custodian;

(b) collusion—for example, an employee colluding with a custodian to process false investment instructions, causing investors' money to be misappropriated to fake investment accounts;

(c) false documents—as many processes are often document driven, the risk of false documents being used to perpetuate the misappropriation of investor money is a significant threat;

(d) manipulation of IT systems—for example, false payments to suppliers or 'ghost' employees; and

(e) securities fraud—this type of fraud may expose investors to significant losses and includes:

    (i) front running;

    (ii) penny-stock schemes;

    (iii) boiler rooms; and

    (iv) microcap stock frauds.

RG 259.131 The following are red flags that may indicate that an investment is subject to an increased risk of fraud:

(a) penny stocks or unusual over-the-counter (OTC) investments;

(b) investments located in tax havens;

(c) investments lacking in transparency. This might be due to the use of nominee accounts hiding the identity of beneficial owners;

(d) excessively complex or unusual investment structures;

(e) lack of audited accounts;

(f) lack of independent directors;

(g) lack of independent valuations for assets;

(h) any unusual or unexplained adjustments to accounts; and

(i) unusual asset statements.

RG 259.132 The identification of effective fraud risk treatments relies on the implementation of:

(a) an enterprise-wide fraud risk management framework that effectively identifies, analyses, evaluates and treats fraud risks affecting operations; and

(b) a code of conduct or similar document that guides all employees' conduct and clearly sets out expectations of employee behaviour, measures used to monitor behaviour, processes for managing conflicts of interest and methods of internal reporting.

Examples of risk treatments

Fund operators can treat this risk by:

- segregating duties, particularly for staff involved in high-risk functions;
- maintaining an internal audit function;
- conducting peer reviews;
- reporting unusual events;
- implementing whistleblower policies, including externally managed confidential hotlines;
- rotating staff involved in high-risk functions;
- requiring dual approvals for significant transactions;
- obtaining regular independent valuations of underlying assets;
- ensuring transparency of investments;
- being alert to any back-channel or undisclosed commission payments, particularly between investment managers and product providers;
- ensuring regular reporting from external service providers;
- taking care when dealing with products that are not researched and have no proven track record; and
- implementing effective and comprehensive due diligence processes.

Market and investment risk

RG 259.133 Market and investment risk is the risk that a fund operated by a fund operator will not meet its objectives.

RG 259.134 Specific investment risks include those relating to:

(a) investment governance and structure (see RG 259.135–RG 259.136);

(b) market conditions (see RG 259.137–RG 259.138);

(c) leverage and short selling (see RG 259.139–RG 259.140);

(d) counterparty failure (see RG 259.141–RG 259.142);

(e) product suitability (see RG 259.143); and

(f) valuation and pricing (see RG 259.144–RG 259.146).

Investment governance and structure

RG 259.135 There is a risk that a fund operated by a fund operator may not meet its objectives due to an inadequate framework for the selection and ongoing monitoring of the performance of the underlying investments of the fund.

RG 259.136 A risk also arises if a fund operator's fund is exposed to a financial product through a multi-layered structure where the fund invests in an investment vehicle, which in turn invests in another investment vehicle. Such a structure may create difficulties in identifying the fund's extent of exposure to a particular financial product, or type of product, arising from investment in multiple investment vehicles. This risk may be exacerbated when one or more of the investment vehicles are not subject to the regulation of Australian laws.

Examples of risk treatments

Fund operators can treat this risk by establishing and implementing an adequate investment governance framework that takes into account:

- whether the fund will be a liquid fund and how withdrawals will be made available;
- whether the fund is exposed to counterparty risk and, if so, monitoring the extent of that risk exposure regularly;
- comprehensive and effective due diligence processes for investment selection when implementing investment strategies; and
- objective measures to monitor the performance of investments at appropriate intervals, provide feedback information to review investments and, if appropriate, update the investment governance framework.

Fund operators can also implement control processes to track the fund's adherence to its stated objectives, investment policy and strategy, and other restrictions, and take appropriate action if a breach occurs.

Market conditions and volatility

RG 259.137 There is a risk that the performance of the underlying assets of a fund will be adversely impacted as a result of changes in market conditions.

RG 259.138 Our regulatory experience indicates that some fund operators consider disclosure of this risk to investors alone as sufficient. We do not consider that this is the case where fund operators actively manage funds. For example, while disclosure of market risk may be appropriate for an index tracking fund that uses complete physical replication of the index, we would expect that fund operators would have processes in place to effectively manage market risk in other circumstances in addition to disclosure.

Examples of risk treatments

Fund operators can treat this risk by:

- implementing policies and procedures for assessing on an ongoing basis forecast performance of the assets of the funds they operate, to identify whether the performance is consistent with expectations and can withstand a range of stress-tested events; and
- continuously monitoring the market for assets the fund holds to identify any emerging issues or trends.

Leverage and short selling

RG 259.139 There are risks associated with the use of debt to fund business activities and short selling—in particular, where there is a change in market conditions.

RG 259.140 Our regulatory experience indicates that some fund operators have been unable to repay or refinance debt arrangements when due, or have significantly exceeded leverage ratios disclosed to investors. We have also identified that fund operators are using various forms of leverage—including derivatives, which may create synthetic leverage. In addition, losses have been suffered as a result of short selling activities.

Examples of risk treatments

Fund operators can treat this risk by:

- implementing appropriate leverage ratios and ensuring ongoing monitoring of compliance with the ratios based on recent asset valuations;
- implementing appropriate limits on the amount of the portfolio lent or borrowed at any one time;
- continuously monitoring market conditions to identify emerging issues or trends;
- implementing strategies to manage related counterparty risks (see 'counterparty failure' risk treatment strategies at RG 259.142);
- continuously monitoring liquidity and the impact of default and short selling positions on the fund operator and the fund; and
- ensuring appropriate disclosure to investors of the use of leverage and short selling. This includes compliance with any specific disclosure and reporting requirements that are relevant to the particular fund. For example, Disclosure Principles 6, 7 and 8 for hedge funds in Regulatory Guide 240 *Hedge funds: Improving disclosure* (RG 240) and the requirements in Section D of Regulatory Guide 196 *Short selling* (RG 196) for short selling.

Counterparty failure

RG 259.141 There is risk a counterparty will fail to meet its obligations and that the fund operator cannot put in place a replacement transaction economically and efficiently to meet any ongoing obligations.

RG 259.142 Any assessment of counterparty risk should take into account the type and extent of counterparty risk the business or relevant funds are exposed to. We do not consider, for example, that a generic approach to reviewing the business's counterparty risk exposure once a month is necessarily sufficient.

Examples of risk treatments

Fund operators can treat this risk by:

- having a process for setting up counterparty relationships, including the assessment of creditworthiness and setting of risk limits;
- carrying out due diligence inquiries into counterparties;
- ensuring agreements entered into include regular valuations, collateral standards (i.e. requirements for essential performance) and indemnification commitments (i.e. the requirement for a payment in the event of non-compliance);
- regularly assessing the creditworthiness of the counterparty and the impact of counterparty default on the financial position of the business or relevant funds;
- adjusting risk limits where required; and
- avoiding excessive reliance on a limited number of counterparties.

Product suitability

RG 259.143 There is a risk that a product design may become unsuitable for the needs of current and potential fund members or the needs of the business.

Examples of risk treatments

Fund operators can treat this risk by:

- carrying out consumer research on product suitability;
- having consumer warnings and knowledge tests for complex products; and
- regularly assessing ongoing product suitability.

Valuation and pricing

RG 259.144 At the fund level, there is a risk of fund assets not having a correct and current valuation. Robust valuation practices are essential for effective liquidity risk management and correct pricing of interests in most registered funds.

Note: Where issue and redemption of fund interests or shares is permitted, valuation policies may be required to be consistent with ordinary commercial practice and result in a value that is reasonably current: see Regulatory Guide 134 *Funds management: Constitutions* (RG 134). In accordance with s601HA(1)(c), the compliance plan must set out adequate procedures for ensuring that the fund property is valued at regular intervals appropriate to the nature of the fund property.

RG 259.145 This risk is generally higher for funds that invest in assets that are not traded on a financial market or assets that do not have a liquid market (e.g. mortgage or property funds), where the market price of fund assets is more difficult to determine.

RG 259.146 In our regulatory experience, some constitutions or compliance plans only require a fund operator to value fund assets at specific intervals or use a qualified independent valuer, as required by the Corporations Act. This can present a risk to members of the fund that valuations are outdated and inappropriate to rely on when assessing their investment.

Examples of risk treatments

Fund operators can treat this risk by:

- implementing valuation policies that take into consideration factors such as the type of assets a fund invests in and the operating model of the fund (e.g. whether it allows issue and redemption of interests);
- carrying out regular independent valuations;
- rotating valuers used to value fund assets; and
- segregating the internal functions in charge of calculation of net asset value (NAV) and maintenance of accounting records from the investment management function.

Liquidity risk

RG 259.147 Liquidity risk is the risk that the fund operator will not have adequate financial resources to meet its financial obligations and needs, either:

(a) at the fund operator level (see RG 259.148–RG 259.151); or

(b) at the fund level, including meeting the fund's objectives and members' expectations for redemptions (see RG 259.152–RG 259.155).

At the fund operator level

RG 259.148 RG 166 sets out the financial requirements for AFS licensees that are fund operators. In summary, fund operators must meet:

(a) the standard solvency and positive net assets requirement;

(b) a tailored cash needs requirement;

(c) a tailored audit requirement;

(d) a net tangible assets (NTA) requirement, including requirements for holding at least 50% of the NTA requirement in liquid assets; and

(e) depending on the financial products and services offered, any other requirements set out in RG 166 that apply.

Note: Our general expectation is that the risk management systems need to address the risk that an entity's financial resources will not be adequate. RG 166 sets out more information on the financial requirements for responsible entities (see Appendix 2) and for corporate directors (see Appendix 10).

RG 259.149 In our regulatory experience, we have seen a number of fund operators become insolvent and unable to maintain their AFS licences or operate their funds. This could be a result of market conditions putting pressure on less robust business models in the managed funds sector or inadequate fee structures, where the entity receives less than expected management fees after the initial phase of the fund's operation (although it is otherwise envisaged that the fund will operate over decades).

RG 259.150 Such mismatches in the internal and external contexts in which the risk management systems are developed give rise to risks that a fund operator will not have sufficient financial resources to operate its business, including the relevant funds, in accordance with its strategic and business objectives and those of the funds.

RG 259.151 If the fund operator also operates wholesale funds or superannuation trusts or conducts any other business, the operation of these other funds, trusts or businesses may affect its cash flow or liquidity and should be taken into account in assessing any liquidity risk.

Examples of risk treatments

Fund operators can treat this risk by:

- implementing a liquidity risk management process that includes ongoing assessment of their compliance with the financial requirements of their AFS licence and ability to meet all other financial obligations and needs; and
- internally auditing high-risk areas of the business, including management of liquid assets, pricing of assets and investment.

At the fund level

RG 259.152 In our regulatory experience, fund operators that invest in assets that are not well traded on a financial market, or do not have a liquid market (e.g. mortgage or property funds), face particular challenges in managing liquidity risk within the funds they operate.

RG 259.153 The importance of good liquidity risk management was evident in the wide-scale suspension of redemptions in the mortgage fund sector when those funds with limited liquidity experienced increased investor demand for redemptions in 2008 and subsequent periods.

RG 259.154 Fund operators need to identify and address the risk of not being able to meet short-term commitments and the risk of the misalignment of members' expectations on liquidity and the capacity of the fund's assets to be realised to meet those expectations.

RG 259.155 Some funds may be subject to specific risks relating to market liquidity, which need to be considered by the fund operator. An example is market liquidity based risks for funds that have interests quoted on a licensed financial market but undertake regular issue and redemption, such as exchange traded funds. The market may not be adequately maintained for the fund to allow trading at a price at or near the NAV in line with investor expectations. Operators of these funds need to identify and address this risk.

Examples of risk treatments

Fund operators can treat liquidity risk by establishing and implementing an effective liquidity risk management process that incorporates:

- compliance with any specific disclosure requirements that are relevant to the particular fund. For example, Benchmark 1 and Disclosure Principle 1 in Regulatory Guide 45 *Mortgage schemes: Improving disclosure for retail investors* (RG 45), which applies to unlisted mortgage schemes, and Disclosure Principle 5 for hedge funds in RG 240;
- appropriate internal thresholds for liquidity, which are proportionate to the redemption obligations and ongoing commitments of the funds;
- tools to identify an emerging liquidity shortage before it occurs. For example, comparisons of the performance of funds to their peer groups, including trends in issue and redemption of interests;
- ongoing assessments of the liquidity profile of the assets and liabilities (including the fund's investor profile and investors' historical and expected redemption patterns) held by the funds to ensure they will be able to meet investor expectations about redemptions and other ongoing commitments;
- regular assessments of liquidity in different scenarios, including stress testing or scenario analysis;
- the use of tools to manage liquidity (when appropriate) and the regular assessment of those tools. Examples of liquidity risk management tools include redemption fees, suspension of withdrawal requests, redemption gates, *in specie* transfers, swing pricing, minimum or maximum limits on withdrawals, or satisfying withdrawals on a partial or staggered basis (see RG 259.48 for an explanation of these tools);
- access to relevant information about liquidity management for investments, such as information about the investor profile and liquidity management approach adopted by the underlying funds the funds invest in;
- appropriate oversight of the ongoing liquidity assessments by senior management;
- liquidity practices consistent with industry and international guidance (for additional guidance, see the IOSCO Recommendations for Liquidity Risk Management for Collective Investment Schemes and the FSB Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities);
- regular periodic reviews of the effectiveness of the liquidity risk management process and updating the process as appropriate;

- consideration of how any advertising, marketing and distribution of the fund may impact on liquidity and regular reviews of advertising and marketing materials to ensure they accurately reflect the fund's liquidity profile and any redemption rights offered;
- appropriate disclosure in PDSs for the fund of investor redemption rights, liquidity risks, the liquidity management process and if the fund operator has the power to use any liquidity risk management tools;
- disclosure to existing investors of any material changes to the liquidity risk and the use of liquidity risk management tools;
- consideration of the potential impact of investments on the fund's overall liquidity before investment decisions are made;
- ensuring that the frequency of dealing in units or shares in the fund and investor redemption rights are compatible with the fund's liquidity profile, investment strategy and portfolio composition; and
- early engagement with the regulator regarding liquidity events that may impact investors.

Market liquidity based risk for quoted funds

Operators of quoted funds can manage market liquidity based risk by:

- having appropriate arrangements with a market maker, unless the fund operator is making a market for the fund and/or a sufficient number of authorised participants are reasonably likely to trade the fund in order to provide liquidity at or close to NAV on any ongoing basis;
- closely monitoring the fund's market price on a continuous basis and, if it deviates materially from the NAV, considering suspending trading of the fund;
- maintaining an up-to-date and reliable indicative NAV; and
- encouraging investors to check the market price against the indicative NAV before they trade and disclosing to investors the risk that there may be times where they cannot sell their interests or sell at a price near the NAV.

Key terms

Term	Meaning in this document
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services Note: This is a definition contained in s761A of the Corporations Act.
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act
ASIC	Australian Securities and Investments Commission
board	A fund operator's board of directors
[CO 13/760] (for example)	An ASIC class order (in this example numbered 13/760) Note: Legislative instruments made from 2015 are referred to as ASIC instruments.
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
CCIV	A corporate collective investment vehicle—a company that is registered as a corporate collective investment vehicle under the Corporations Act Note: This is a definition contained in s9 of the Corporations Act.
FSB	Financial Stability Board
fund	A registered scheme or CCIV (including, where the context requires, a sub-fund of a CCIV)
fund operator	The responsible entity of a registered scheme or a corporate director of a CCIV
governance risk	Has the meaning given in RG 259.70(b)
IDPS	Investor directed portfolio service, as defined in Class Order [CO 13/763] *Investor directed portfolio services* or any instrument that amends or replaces that class order
IOSCO	International Organization of Securities Commissions
liquidity risk	Has the meaning given in RG 259.70(e)
market and investment risk	Has the meaning given in RG 259.70(d)
MDA	Managed discretionary account
NAV	Net asset value

Term	Meaning in this document
NTA	Net tangible assets
operational risk	Has the meaning given in RG 259.70(c)
PDS	A Product Disclosure Statement—a document that must be given to a retail client for the offer or issue of a financial product in accordance with Div 2 of Pt 7.9 of the Corporations Act Note: See s761A for the exact definition.
PI insurance	Professional indemnity insurance
RG 104 (for example)	An ASIC regulatory guide (in this example numbered 104)
REP 429 (for example)	An ASIC report (in this example numbered 429)
registered scheme	A managed investment scheme that is registered under s601EB of the Corporations Act
s912A (for example)	A section of the Corporations Act (in this example numbered 912A)
strategic risk	Has the meaning given in RG 259.70(a)
sub-fund	Has the meaning given in s1222Q of the Corporations Act Note: A sub-fund is established on the day on which it is registered: see s1222T.

Related information

Headnotes

AFS licences, assessing risks, Australian financial services licensees, CCIVs, corporate collective investment vehicles, corporate directors, fund operators, funds, good practice guidance, identifying risks, managing risks, responsible entities, risk management systems, risk treatments

Regulatory guides

RG 45 *Mortgage schemes: Improving disclosure for retail investors*

RG 76 *Related party transactions*

RG 78 *Breach reporting by AFS licensees and credit licensees*

RG 104 *AFS licensing: Meeting the general obligations*

RG 126 *Compensation and insurance arrangements for AFS licensees*

RG 132 *Funds management: Compliance and oversight*

RG 134 *Funds management: Constitutions*

RG 166 *AFS licensing: Financial requirements*

RG 196 *Short selling*

RG 240 *Hedge funds: Improving disclosure*

Consultation papers

CP 204 *Risk management systems of responsible entities*

CP 263 *Risk management systems of responsible entities: Further proposals*

Reports

REP 429 *Cyber resilience: Health check*

Legislative instruments

ASIC Corporations (Financial Requirements for Corporate Directors of Retail Corporate Collective Investment Vehicles) Instrument 2022/449

[CO 13/760] *Financial requirements for responsible entities and operators of investor directed portfolio services*

Legislation

Corporations Act 2001, Pt 7.9; s601FB, 601HA, 601HA(1)(c), 601HA(1)(e), 912A(1)(d), 912A(1)(h), 912B, 912DAA, 1224M, 1226A

Other documents

FSB, *Policy recommendations to address structural vulnerabilities from asset management activities*

International Monetary Fund, *Macrofinancial stress testing—Principles and practices* (PDF 1.18 MB)

IOSCO, *Recommendations for liquidity risk management for collective investment schemes: Final report* (PDF 363 KB)

ISO 31000:2018 *Risk management—Guidelines*