

Morgan Lewis

Re-assessing Risk and the Annual Review in Current Market Conditions

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Reassessing Risk and the Annual Review in Current Market Conditions

- **Identify.** Think back to your crises: what new risks arose? What changed?
- **Manage.** Do your procedures address changed risks?
- **Mitigate.** Fix your procedures and disclosures; resolve problems and document results.
- **Incorporate.** Add “I,M,M,” into the annual review and ongoing risk management.

The Annual Review: What does the SEC say about Risk Assessment?

- “[E]ach adviser should identify its unique set of risks, both as the starting point for developing its compliance policies and procedures and as part of its periodic assessment of the continued effectiveness of these policies and procedures.”
- “Provide a current inventory of the Adviser’s compliance risks. If changes were made to this inventory of risks during the Examination Period, please indicate what these changes were and the corresponding date of the change.”
 - Does the firm’s inventory identify where information flows? Where funds and securities flow?
 - Does it show how for each risk, a control is in place? That the control has been implemented? Who is responsible?

How Have Market Events Affected the Risks the Firm Faces?

- Pricing services and credit ratings became unreliable
- Selection & due diligence of counterparties got harder
- Some markets suddenly frozen / illiquid
- Portfolio managers pushed guideline limits to recoup losses
- Out of date disclosure about a strategy's risks
- Clients sought to go defensive without backup in file
- Questionable principal or cross trades to hide problems
- Safety of assets was in question
- Return to “surprise” exams

Pricing Services and Credit Ratings Became Unreliable

- Identify
 - A rise in manager challenges
 - Stale prices, difficulty in getting prices
 - Ratings unchanged or sell discipline ignored despite bad news about issuer
 - Increased calls to managers for their opinion
 - Material discrepancies between carrying prices and sale prices

Pricing Services and Credit Ratings Became Unreliable

- Manage & Mitigate
 - What did you tell your clients about valuation, and does it match your policies?
 - Do your policies permit fair value pricing?
 - Do you need to notify clients that you are fair valuing their securities?
 - Should the firm use more than one pricing source?

Selection and Due Diligence of Counterparties

- Identify
 - Counterparties slow to respond or acknowledge problems and errors
 - Counterparties disappear, leaving firm with fewer choices
 - Counterparties go under and firm's trades are frozen; firm must deal with receiver

Selection and Due Diligence of Counterparties

- Manage & Mitigate
 - Ranking brokers twice a year for their good research is not enough
 - Monitor their solvency on a risk-weighted basis
 - Ask the traders about the firm – are there hints of a problem?
 - Counterparty risk
 - Should you use just one counterparty?
 - If client selects the counterparty, make that clear in your agreement
 - Monitor the counterparty's health: SAS 70, internal controls, certifications, on-site visits, and “asking around.”

Markets Freeze Up

- Identify
 - Auction rate securities, municipal bonds, and Treasury repos have all frozen in the last 2 years
 - Valuation problems in a frozen market – “someday” vs. “now” suitability and valuation; overcharging advisory fees
 - Misallocation of limited sales or exchange opportunities; treating clients unequally
 - Client terminations
 - In kind payments of illiquid securities may anger clients; paying out cash may mean later-withdrawing clients get no cash.

Markets Freeze Up

- Manage & Mitigate
 - Review disclosures to clients about liquidity; review valuation policy on stale / frozen prices
 - Revise allocation procedures to address terminating clients and allocation of limited sales or exchange opportunities (not just purchases)
 - Watch for unusual or small sales or exchanges at prices above last-quoted market price or form's current price

Disclosing a Strategy's Risks

- Identify
 - Client complaints about use of unapproved/undisclosed securities and strategies
 - Regulators criticize securities your firm uses in client accounts
 - Auction rates – firms were blindsided
 - Target date funds
 - Leveraged and inverse ETFs
 - Strategy/management affected by market conditions (e.g. large cap holdings become small cap holdings)

Disclosing a Strategy's Risks

- Manage & Mitigate
 - Compare client accounts or model with the firm's marketing materials about strategy composition and benchmarks
 - The disclosure that worked last year may not work this year, so look at press reports, new fund filings, and SEC speeches to gauge changes to a strategy's risks

Pushing Guidelines to Recoup Losses

- Identify
 - Watch for cross trades to cover up guideline violations
 - Aggressive interpretation of guidelines
 - “Generally”, “substantially”, “under normal market conditions”
 - Percentage limits – always or only at time of purchase
 - “If the guidelines don’t prohibit it . . .”
 - New types of investments added without prior consultation with the client

Pushing Guidelines to Recoup Losses

- Manage & Mitigate
 - Increase frequency of guideline reviews
 - Query the reasons for cross trades – Rule 17a-7 reports typically ask for a manager justification on both sides of the trades
 - Ask clients to clarify vague terms in guidelines, and tighten up the firm's own template guidelines

Clients Seek Defensive Investments

- Identify
 - **Unauthorized changes in account holdings**
 - Clients want their accounts in cash despite questionnaire answers that say they are comfortable in equities (B-D focused – consider “despite investment guidelines directing investment in equities”)
 - Employees (took out reps) make changes on oral instructions with no backup
 - **Complaints rise in a bad market**
 - Client questionnaires/advisers don’t ask the hard questions (“what if your account lost 30% in a year?”)

Clients Seek Defensive Investments

- Manage & Mitigate
 - Document changes and send to client
 - Decide what “defensive” or “all cash” means. Does your firm have a such a strategy?
 - How does the firm handle clients giving directions in a discretionary account? What about composite inclusion, performance disclosures?
 - At what point is the adviser’s style no longer suitable for the client?
 - When will the client go back into the market? Whose decision is it? How often should the firm discuss this with the client?
 - When the markets come back, will clients sue if they missed the rise?

Using Principal and Cross Trades to Hide Losses

- Managers trying to make up client losses or smooth performance
- Red flags:
 - Watch for a spike in the number of these trades, especially for clients who have complained
 - Round trips to brokers, where the broker holds for a very short period
 - Trades involving illiquid securities

Using Principal and Cross Trades to Hide Losses

- Manage & Mitigate
 - Increase monitoring of principal and cross trades; watch for performance laggards getting crossed
 - Require written justification and preapproval of these trades

Safety of Client Assets

- Identify
 - The Madoff and Stanford fallout – how does your firm know that qualified custodians are used upstream?
 - Use of offshore custodians
 - Small accounting firms auditing large hedge funds
 - Self-custody or custody with affiliates
 - Access to funds as trustee or general partner

Safety of Client Assets

- Manage & Mitigate
 - Downstream subadvisers and wrap account managers should try to verify custody upstream
 - Fund of funds investments: can the firm walk back the custody chain and verify actual underlying assets?
 - Bread & butter – review reconciliation process and documentation, review adviser account statements, sample statements from custodian, review client addresses on file at custodian, etc.

Reassessing the Risk of an SEC Exam – Surprise Exams are Back

- Identify
 - SEC staff is giving shortened notice of some exams – 24 - 48 hours
 - “Rave” exams
 - New and longtime advisers get a visit from the staff, who talk to management first

Reassessing the Risk of an SEC Exam – Surprise Exams are Back

- Manage & Mitigate
 - Interview personnel to determine their understanding and impressions of the existing procedures:
 - “At various times during fieldwork, the staff will also want to interview persons responsible for such functions as portfolio management, trade execution, back office/administration, information technology, anti-money laundering and marketing.”
 - Make sure your firm is ready to produce – tie responsible persons and document names and locations to each item in a recent exam request
 - Ask personnel to read the policies that apply to them

Enforcement of Rule 206(4)-7 – Inadequate Procedures and Risk Matrices

- *CapitalWorks Investment Partners, LLC* (June 6, 2006).
 - No written policies or procedures relating to client communications, including RFPs.
- *Consulting Services Group, LLC* (October 4, 2007).
 - CSG failed to undertake adequate efforts to identify risk factors or specific conflicts applicable to its operations as a pension consultant and affiliated broker.
 - An example of what can go wrong with use of pre-packaged compliance manuals and procedure templates.

Enforcement of Rule 206(4)-7 – Investigate Red Flags of Risky Practices

- *Battery Wealth Management* (October 15, 2008): CCO & minority owner paid \$40k penalty and got a 1 year time out for ignoring signs of fraud - lavish spending, cash flow problems, and problems meeting redemptions.
- *American Skandia* (April 17, 2009): Adviser failed adequately to investigate sub-advisers' complaints that market timing was hurting performance and failed properly to determine the harm to investors. \$68m in disgorged fees and penalties.
- *Hennessee Group* (April 22, 2009): Adviser failed to investigate several pieces of inconsistent information about auditor to Bayou hedge funds.

Enforcement of Rule 206(4)-7 – Live by your Compliance Manual

- If it's in your compliance manual, do it
 - Quattro Global Capital (August 15, 2007) – \$100k penalty for failure to file Forms 13F; order noted that the compliance manual required this
 - Hunt for the “shalls” and “wills” in your manual and make a list
 - The passive voice is not your friend - “Trades will be reviewed.”
- Follow your disclosures
 - Hennessee – \$715k penalty for failure to perform two of five advertised elements of due diligence on hedge funds

Incorporate Into Annual Review

- Annual review should include identification of these new risks
- Annual review should incorporate testing protocols to address potential issues
- Annual review should include documentation of how these risks were managed and mitigated
- Be prepared to answer SEC staff questions raised by new reality

Incorporate into Firm's Risk Management

- Compliance risk only one piece
- Investment and operational risk issues significantly affected by market conditions
- Business units responsible for investment and operational risk
- Compliance personnel on risk committee or otherwise integrated into overall assessment
- Risks identified in annual review process shared with risk committee or similar group

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