

Morgan Lewis

collaborate
Ascendant Compliance Conference

September 26-28, 2010

Errors and Error Correction

Steven W. Stone
Morgan, Lewis & Bockius LLP

www.morganlewis.com

Errors and Error Correction

- Overview
- Legal Framework
- 30 Questions
 - The basics
 - How do we respond?
 - Loss calculations
 - Client dealings
 - Process and procedure related questions
- Examples

Overview


- The subject of errors and error correction it is one of the most difficult for investment advisers
- This is because
 - there is no clearly defined legal framework
 - each error may be different based on the particular facts
- For this reason, asking the right questions and having a consistent framework for error assessment and correction is critical

Legal Framework

- As fiduciaries, advisers are subject to the duties of care and loyalty of a fiduciary when acting as such
 - This is different than the standard of care expected of an ordinary person because
 - *an adviser expressly or impliedly holds itself out as having greater skill than the ordinary person*
 - *clients rely on their advisers to use greater skill than an ordinary person*

Legal Framework

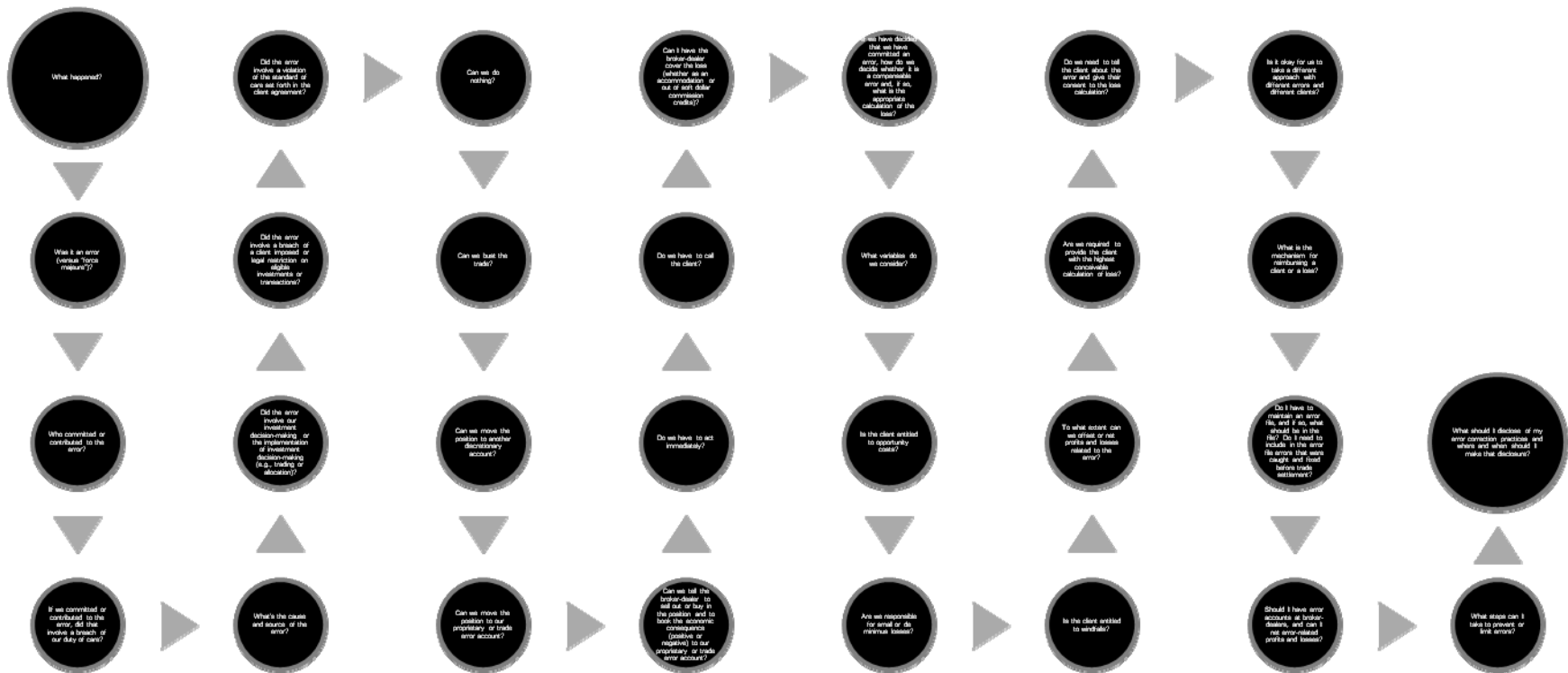
- The standard of care expected of advisers is nowhere specifically delineated by statute, rule or regulation
 - The Restatement of the Law of Trusts provides a useful framework
- Advisers may specify the standard of care and their responsibility for breaches of that standard care in their client agreements
 - However, contractual provisions that unreasonably seek to disclaim responsibility or liability will not be enforced (and may be viewed as fraudulent)



Errors and Error Correction

30 Questions

Error Correction Roadmap



The Basics

1. What happened?
2. Was it an error (versus “force majeure”)?
3. Who committed or contributed to the error?
4. If we committed or contributed to the error, did that involve a breach of our duty of care?
5. What’s the cause and source of the error?
6. Did the error involve our investment decision-making or the implementation of investment decision-making (e.g., trading or allocation)?
7. Did the error involve a breach of a client imposed or legal restriction on eligible investments or transactions?
8. Did the error involve a violation of the standard of care set forth in the client agreement?

How do we respond?

9. Can we do nothing?
10. Can we bust the trade?
11. Can we move the position to another discretionary account?
12. Can we move the position to our proprietary or trade error account?
13. Can we tell the broker-dealer to sell out or buy in the position and to book the economic consequence (positive or negative) to our proprietary or trade error account?
14. Do we have to act immediately?
15. Do we have to call the client?
16. Can I have the broker-dealer cover the loss (whether as an accommodation or out of soft dollar commission credits)?

Loss calculations

17. If we have decided that we have committed an error, how do we decide whether it is a compensable error and, if so, what is the appropriate calculation of the loss?
18. What variables do we consider?
19. Is the client entitled to opportunity costs?
20. Are we responsible for small or de minimus losses?
21. Is the client entitled to windfalls?
22. To what extent can we offset or net profits and losses related to the error?
23. Are we required to provide the client with the highest conceivable calculation of loss?

Client dealings

- 24. Do we need to tell the client about the error and give their consent to the loss calculation?
- 25. Is it okay for us to take a different approach with different errors and different clients?
- 26. What is the mechanism for reimbursing a client or a loss?

Process & procedure related questions

27. Do I have to maintain an error file, and if so, what should be in the file? Do I need to include in the error file errors that were caught and fixed before trade settlement?
28. Should I have error accounts at broker-dealers, and can I net error-related profits and losses?
29. What steps can I take to prevent or limit errors?
30. What should I disclose of my error correction practices and where and when should I make that disclosure?



Examples

Example 1

- Client instructs an adviser that the adviser should not invest the account in any sin stocks, with sin stocks defined as issued by companies that derive 29% or more of their revenues from sin related businesses
 - Variation 1: Adviser mistakenly invested in SinCo based on publicly file reports showing that for prior periods SinCo's sin related activities were below the threshold but the next filed reports for the quarter in which the investment was made disclosed that sin related revenues in fact had exceeded the client threshold
 - Variation 2: Same as above, but the adviser relied on stale information published by a vendor that showed the SinCo's sin-related revenues as below the client threshold
 - Variation 3: Same as above, but while adviser had invested when SinCo's revenues were below the threshold, they subsequently surpassed the threshold

Example 2

- Mutual fund has a fundamental investment policy prohibiting the investment of the fund's assets in securities issued by open-end investment companies
- The adviser has a disclosed policy of maximizing the amount invested and seeks to invest cash balances in index ETFs corresponding to the fund's strategy
- To pursue the adviser's strategy of equitizing cash balances, the adviser invested in ETFs closely tracking the portfolio strategy, including open-end investment companies, the value of which declined as did the portfolio as a whole

Example 3

- Adviser has a quantitative investment strategy based on a complicated algorithm
- Adviser discovers that the programming of the algorithm was inconsistent with the logic the adviser's personnel had intended
- The resulting performance was different than would have been the case if the coding were done correctly, sometimes better – sometimes worse