



NSCP NATIONAL MEMBERSHIP MEETING

Advanced Compliance Concepts

for Investment Advisers

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C O U N S E L O R S A T L A W

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Advanced Compliance Concepts

- Regulation by Enforcement
- Focus on Conflicts . . . And What to do About it
- Risk Assessment
- “Game Theory” Meets Compliance



Regulation by Enforcement

- Enforcers are getting out ahead of regulators
- Aggressive investigative techniques
- “They Don’t Get It” Mentality
- Piling on
- “Where was Compliance”?
- Everyone must adapt to new environment



Focus on Conflicts

- Recent SEC Statements
- Illustrations
 - Conflicts & Stock Selection
 - Conflicts & Reciprocal Brokerage
 - “Ripped from the Headlines”
- Framework for Regulating Conflicts
- Managing Conflicts



Focus on Conflicts

- SEC Enforcement Director Steve Cutler:
 - “Just because a certain way of doing things is second nature to you, and appears to be standard operating procedure on the Street, doesn't mean it's the correct way of doing things.”
- SEC Market Regulation Director Annette Nazareth
 - “There is no safety in numbers. You cannot hide under the shade of ‘standard industry practice.’ Firms that ignore conflicts of interest do so at their peril.”




Conflicts & Stock Selection

- **Interests in securities**
 - Affiliate stock
 - Client stock
 - Business partner stock
 - Managed mutual funds
 - Stocks underwritten by an affiliate
- **Proprietary and personal securities trading**
- **Directorships in companies**
- **Possession of material, nonpublic information**



Conflicts & Reciprocal Brokerage

- SEC and Congressional focus
- Line of past enforcement cases
- Issues for Advisers
 - Fiduciary obligations
 - Best execution & interpositioning concerns
 - Rule 12b-1 issues
 - Board Monitoring
 - Disclosure
- Structure matters



“Ripped from the Headlines”

- **Late Trading & Waiver of Trading Limits or Redemption Fees for “Sticky deals”**
- **Selective disclosure**
- **Employee trading advised funds in 401(k) accounts**



Framework for Regulating Conflicts

- **Focus on:**

- Disclosure
- Consent
- Ultimate fairness

- Most SEC requirements relating to conflicts are found under:
 - Section 206 & Form ADV
 - Section 17 of the Investment Company Act
 - Section 10(b) of the Securities Exchange Act of 1934
- For retirement accounts, ERISA and the IRC add additional requirements



Managing Conflicts

- **Identify and attack conflicts**
 - Limit to the extent possible
 - Establish objective controls
 - Employ practices reasonably designed to achieve fairness
 - Assess disclosure, consent and other requirements
- **Monitor conflicts**
 - Focus on key relationships or interests
- **Separate internal groups having conflicting interests**
 - E.g., Chinese Walls
- **Use disinterested or independent approval**
- **Beef up your contract and ADV disclosure**
 - And make sure your disclosure is accurate



Risk Assessment

- **Statistics to Worry About and Some Focal Points**
- **SEC Approach to Risk**
 - SEC's Ten Critical Areas
- **Illustrations**
 - Portfolio Manager Risk
 - Bond Fund Risk
- **Mapping Responsibility**
- **Practical Guidance on Risk Management**



Risk Assessment

- **Statistics to Worry About**

- Lawsuits targeting fund companies increased 25% between 1998 and 2002
- 2003 will be off the charts
- 66% of paid-out insurance claims - over \$80 million - relate to errors in compliance

- **Five focal points of risk:**

- New products and strategies
- Communication lapses
- Investment restrictions
- Administrative errors
- Intentional misconduct



SEC Approach to Risk

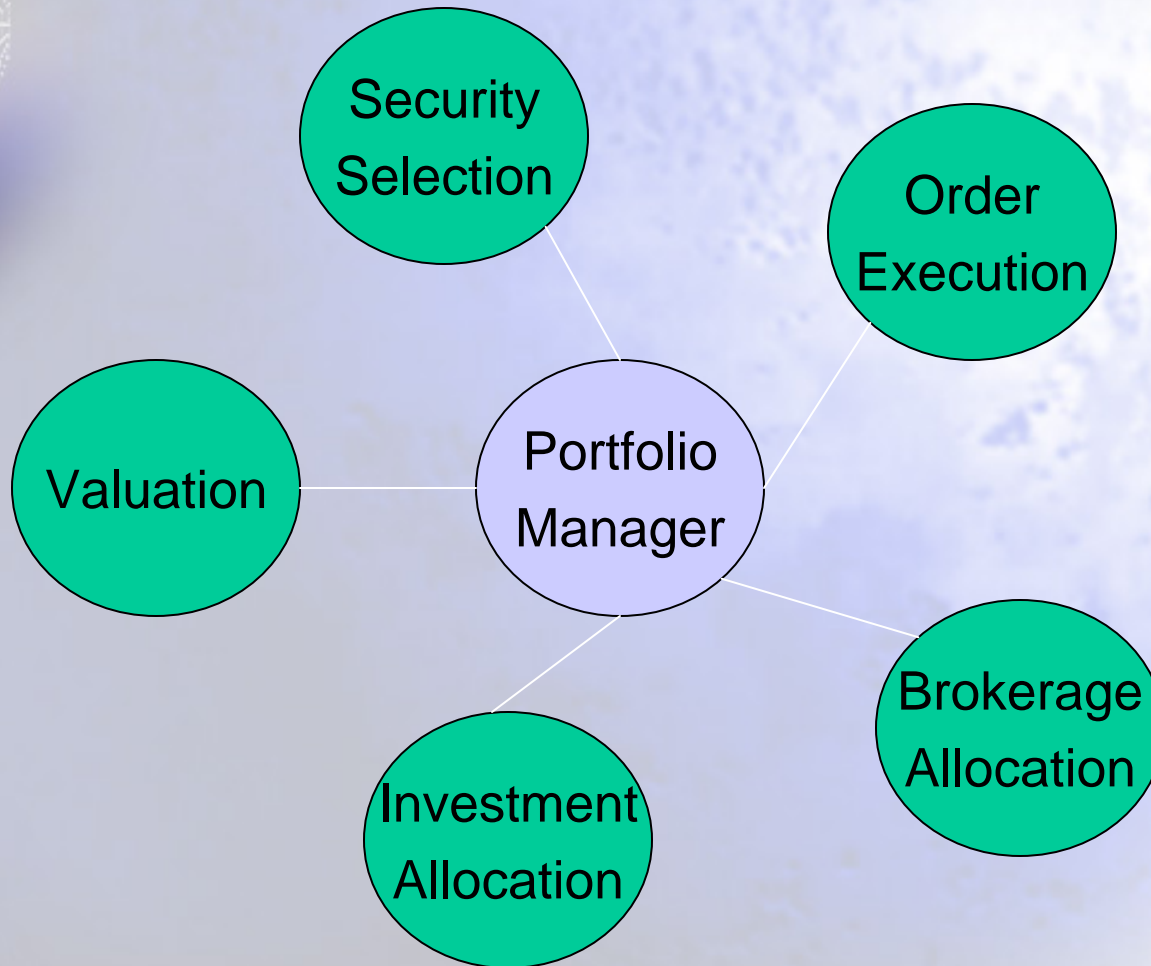
- SEC looks for more than manuals, report forms & checklists
- SEC looks for
 - Effective control, compliance & risk management processes
 - Documents showing how
 - Risks are identified, managed & mitigated in practice
 - Problems are found & resolved promptly
- SEC tests business and compliance controls in critical areas
 - Examples
 - Exception reports
 - Compliance check lists (completed)
 - Reconciliations
 - Compliance work papers
 - Documentation of problem and follow-up resolution
 - Periodic assessments of control and compliance processes



SEC's Ten Critical Areas

- Consistency of portfolio management decisions with client interest
- Order placement practices and consistency with best execution and firm's disclosures
- Allocation of block and IPO trades
- Personal trading and consistency with Code of Ethics
- Securities pricing and net-asset values
- Reconciliation against custodian records
- Controls over information
- Custodian reports to clients about activity in their accounts
- Performance calculations and presentations
- Reconciliation of shareholder transactions

Portfolio Manager Risks






Bond Funds Risks

- Represent disproportionate percentage of claims
 - While dedicated bond funds comprise 19% of industry assets, they account for over 50% of paid-out insurance claims
- When claims arise, they tend to be big
- Claim amounts represent the “tip of the iceberg”



What Makes Bond Funds So Risky?

- Increasing use of complex instruments & derivatives
 - Complex instruments (ABS, CMOs, IOs, mortgage pass throughs, OTC derivatives)
 - Complex strategies
 - Hard for lawyers and compliance personnel to understand
 - “Financial weapons of mass destruction” -- Warren Buffet
- Far array of bonds
 - 9,000 equity securities representing \$11 trillion
 - 3.7 million bonds representing \$17 trillion
- Less transparency
 - Significant events take longer to be reflected in prices
 - Plays into valuation problems
- Yield-based marketing
 - Prompts riskier behavior



Practical Guidance on Risk Management

- Consider how your investment strategies shape risk
 - Yield-based marketing versus preservation of capital
 - Employ risk management tools where appropriate
- Establish a review process for new products & strategies
- Tailor compliance efforts
- Consider whether compensation practices reward risky or improper conduct
- Investigate good and bad performance
- On pricing
 - Use independent pricing services
 - Keep portfolio managers out of pricing
- Police compliance with restrictions
 - Don't accept restrictions you cannot administer or monitor
- Guard against intentional misconduct
 - Team approach
 - Separation of functions
 - Monitor employee trading



Mapping Responsibility

- Compliance is everyone's responsibility
- Overall responsibility – CCO & CLO?
- Ten Key Focus Areas
- Committees
 - Valuation Committee
 - Soft Dollar Committee
 - Best Execution Committee
 - Proxy Voting Committee
- Accountability and Liability



“Game Theory” Meets Compliance

- **Incentive programs for clean internal audits**
- **Production quotas without stepped up surveillance**

How to Deal with Friction Between Compliance and Business



BIT
CA
COM
CPQ
CRU
CS
CSC
CSC



Conflicts Checklist

- **Conflicts between Clients**

- Agency cross and cross trades (§ 206, Rule 206(3)-2 and ERISA limits)
- Allocation of investment and trading opportunities
 - Investment allocation
 - Batching client trades
 - Sequence of client trades

- **Conflicts between Clients' and Adviser's Own Interests – Self-Dealing Conflicts**

- Soft dollars, including mixed use products and commitment to pay residual in hard dollars
- Principal and agency trading (§ 206(3))
- Interests in securities (both as to investment and proxy voting)
 - Affiliate stock
 - Client stock
 - Managed mutual fund
 - Underwritings by an affiliate

- Directorships in companies
- Allocation of investment opportunities (e.g., IPOs)
- Trade errors
- Performance based fees
- Fee differentials for proprietary and nonproprietary products
- Preferred or favored clients
- Double dipping
- Proprietary and personal securities trading
- Parallel trading and front running
- Scalping
- Receipt of transaction-based compensation
- Use of brokerage for referrals and fund sales
- Solicitation arrangements



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