IAWatch
REGULATORY NEWS & COMPLIANCE BEST PRACTICES

Compliance actions to help stem the pressure to push for higher returns

Published on: 9/10/2012

It's as constant as the flow of the Mississippi: the stress to chase better returns. The pressure has only hardened in the yo-yo market of the last few years. Compliance plays a key role in helping to ensure portfolio managers don't stray too far from client investment preferences and steering away from potential trouble (**IA Watch**, May 10, 2010).

"As the CCO ... I see all of the investments, as does the president of the firm," says **Fred Blum**, CCO at **Augustine Asset Management** ($248M in AUM) in Jacksonville, Fla. The daily checks would reveal anything out of bounds, but the firm operates off of standardized portfolios so it would be difficult for a PM to push the boundaries.

David Skelding, VP/GC and CCO at **Christian Brothers Investment Services** ($4B in AUM) in Chicago regularly reaches out to portfolio managers. He goes through "a regular cycle of meetings or phone calls" as well as scheduled quarterly check-ins with subadvisers. A back-end check fingers results. "Was the performance what we would expect to see?" he asks. If a quarter or two goes by with shiny performance compared with peers or benchmarks, this would prompt, "if not a red flag, a pink flag to have more specific conversations" with the manager, he says.

Set investment philosophies bind PMs at **Fiduciary Management** ($12B in AUM) in Milwaukee, says CCO **Kathleen Lauters**. As best practices, she recommends CCOs watch portfolios on a daily basis, if your firm size permits this. Then choose a period - weekly, monthly or quarterly - and look at what's trending. Scour for signs of window dressing, where a PM is "buying things to get that performance to look good at the end of the quarter or the month," she says.

Another tripwire is style drift - gradually moving the portfolio until it doesn't resemble what the client desires, says **Patricia Foster** of **The Law Offices of Patricia C. Foster** in Pittsford, N.Y. "That's a recipe for disaster," she says.

Mark down client wishes

Each client, including those invested in pooled vehicles, should have an investment policy statement (here's an example) that lays out the person's preferences, tolerances and restrictions, she says. Adherence to these statements is "something that should be routinely tested" by compliance officers, Foster continues.

Keep in mind the investment changes may not be caused by a breathing PM but by a humming computer. Foster raises the **SEC** enforcement action against **AXA Rosenberg**, a firm that hid "a significant error" in its computer code that caused $217 million in client losses. We've previously shared tips for dealing with the risk of a faulty computer (**IA Watch**, Aug. 13, 2012).

Be sure to "document the internal due diligence" you do, says **Joel Wattenbarger**, a partner with **Ropes & Gray** in Boston. Ask if your firm was authorized to do the trade and whether it had provided adequate disclosure to investors, he adds. It can be difficult for a CCO to challenge a PM but it's a necessary part of the job, Wattenbarger feels.

Firms are pursuing greater opportunities for clients, be it diversified equities, international exposure, ETFs, private investments tied to everything from art, timber and mortgages or more, says **Michelle Kennedy**, consultant with **Compass Compliance Services** in Greenville, S.C. A mistake firms make is not to review the client agreement and investment profile before venturing into a new arena. This is especially risky if you lack the documentation to demonstrate that a client is a qualified investor and yet you put the person into an inappropriate security. The SEC can be expected to flag this on an exam, she adds.

Another risk pops up when PMs push into new jurisdictions, e.g., Europe, Canada, Brazil, India or Singapore, but the firm's compliance officer isn't familiar with the regulatory rules in these countries.

Consider creating a deal review committee. A New York RIA uses its committee to "vet all the issues" around new business, including regulatory, reputation and jurisdictional risks, says the CCO. "That's a process that we found very effective," he says.

Don't run from risk

Remember that your PMs look at investment risk differently from you. Don't run screaming every time you hear the word risk, says Skelding. Know that there's good risk and bad risk. "Have a reasoned approach to risk," he says. Avoid any temptation to move to immediately shut down an investment you may not totally understand until you do. Ask if the investment corresponds to the client's parameters and has been properly disclosed.

Of course, software can be your ally. **EZE Castle** helps **Barry Greenberg**, GC/CCO at **Cushing MLP Asset Management** ($1.8B in AUM) in Dallas, make sure holdings don't cross into a client's restrictions. A module takes the restriction and produces an exception report for Greenberg to read if something scrapes against a client's preference. He also peruses a daily report of trades for any signs of securities that are on the restricted list and potential cross trades. The firm employs a risk manager who oversees the portfolios from a risk management perspective.

Charles River is the software used by **ING Funds** ($85B in AUM) in Scottsdale, Ariz. CCO **Kevin Gleason** says it forms a 1-2 punch. It's capable of applying a "hard-stop that prevents the trade

from going through" in the first place if it appears the transaction would violate pre-programmed preferences.

On the back-end, Gleason does a check as well, usually on a T+2 basis. It may be prompted by an exceptions report. This could set off a review that ultimately can bust the trade.