Managing Operational Risks of Private Accounts

A Guide for Investment Advisers

ICIMutual
A Risk Retention Group

Managing Operational Risks of Private Accounts

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Introduction

Investment advisers to registered investment companies ("fund advisers") frequently also provide, directly or through affiliates, investment management and related services to wealthy individuals, endowments, retirement plans, and other types of "private accounts." Private account assets at certain fund advisers have increased as much as sevenfold over the past decade, and for some, private accounts now represent a majority of assets under management. For various reasons, and in accordance with the predictions of industry observers, it seems likely that private accounts will remain an important and strategic focus for many fund advisers over the foreseeable future.[1]

Inherent in an adviser's day-to-day management and servicing of private accounts is the risk of operational mistakes: trading errors, failures to follow investment guidelines, mishandling of corporate action requests, and the like. Advisers generally seek to address their mistakes promptly, and most operational errors are resolved between advisers and their clients without having to resort to litigation or other formal legal proceedings. Even so, major errors can have disruptive and adverse effects. Advisers may incur substantial financial losses (in the form of compensatory payments made to the affected client accounts), as well as reputational damage (which, in turn, may contribute to the loss of existing or new business, as well as heightened regulatory scrutiny). Advisory personnel deemed responsible for such errors may find their career advancement jeopardized and may incur substantial professional embarrassment.

ICI Mutual's claims experience suggests that no adviser to private accounts is immune to these risks. Since its formation in 1987, ICI Mutual has paid approximately $620 million in insurance claims, with over $95 million traceable to "costs of correction" claims—i.e., insurance claims involving payments made by advisers, outside the litigation context, to remedy operational errors that have adversely impacted their managed funds or private accounts. Whether measured in terms of frequency or severity, costs of correction claims have disproportionately involved private accounts, particularly in recent years. More specifically, over the past five years, errors in the management and servicing of private accounts have accounted for two thirds of all costs of correction claims received by ICI Mutual, and approximately 65% of all amounts paid by ICI Mutual on such claims.

In light of the foregoing, advisers may conclude that now is an opportune time to review their established programs for managing operational risks in the management and servicing of private accounts. Such reviews may lead some advisers to conclude that modifications to their current programs should be made, while others may conclude that no modifications are necessary. Regardless of the results, advisers are likely to find that there are organizational benefits to the review process itself, including re-sensitizing key advisory personnel to the nature and importance of the risks associated with private account management. This study is intended to assist senior management, legal and compliance personnel, and portfolio managers in their review and discussion of techniques and procedures for reducing these risks.

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[1] Certain advisers have pointed to the relatively lower costs of acquiring new private account assets (as compared to mutual fund assets) as a driver of growth in this area. In addition, the dramatic increase in retirement plan assets in recent years has created new opportunities for advisers with respect to private account management. Since 1999, U.S. retirement assets have increased over 40%, totaling approximately $16.6 trillion as of September 30, 2010. *See* Inv. Co. Inst., The U.S. Retirement Market, Third Quarter 2010, at 6 (Jan. 2011), http://www.ici.org/pdf/ppr_11_retire_q3_10.pdf (chart reflecting U.S. Retirement Assets, 1999 to 2010:Q3).

To that end, this study is structured as follows:

- Part I focuses on the special challenges involved in managing private accounts and the factors that add complexity to the compliance effort.
- Part II catalogues common types of operational errors and oversights involving private accounts.
- Part III explores some of the causative themes underlying these errors and oversights.
- Part IV reviews various risk management techniques that are employed by advisers to address and manage the operational risks associated with private accounts.

The contents of this study reflect ICI Mutual's interviews with investment advisory personnel, consultation with counsel and other industry experts with specialized knowledge regarding the private advisory area and related services, analysis of claims reported to ICI Mutual over its twenty-four year history, and review of publicly available materials.

This study is the latest of a number of risk management studies prepared by ICI Mutual. As with those earlier publications, this study is not intended to, and does not, recommend any single approach or set of "best practices"; one-size-fits-all standards are generally not practical or advisable, given the diversity of the industry, of investment advisers, and of risk management processes and techniques. While the operational risks that advisers face with respect to private account management are generally similar, how individual advisory firms wish to manage these risks may vary substantially based on each adviser's history, structure and culture.

Moreover, nothing in this study should be considered legal advice; rather, readers should look to their counsel for such advice.

Insurance Considerations

Some fund complexes include private advisory coverage in "joint" Directors & Officers/Errors & Omissions ("D&O/E&O") insurance policies that cover registered funds, advisers and other affiliated fund service providers. Other complexes insure private advisory activities under separate, stand-alone D&O/E&O programs that cover only "non-fund" service providers (including advisers) and their parent companies. Approximately one third of ICI Mutual's D&O/E&O insured complexes purchase "joint" D&O/E&O policies that include private advisory coverage.

D&O/E&O policies are typically written on a "claims made" basis, meaning that insurance coverage can be triggered only if a lawsuit (or other "claim") is made against an insured during the policy period. As a practical matter, however, most disagreements between advisers and private advisory clients over legal and financial responsibility for operational errors are likely to be resolved without litigation, and often even without formal "demands" being made. As a result, under traditional D&O/E&O policies, insurance may be unavailable for amounts paid by an insured adviser to resolve such disagreements, unless the client files an actual lawsuit (or, under some policies, unless the client has made a formal demand on the adviser).

ICI Mutual, as well as various commercial insurers, has addressed this issue by providing "costs of correction" or analogous coverage under its D&O/E&O policies. Such coverage permits insured advisers to seek recovery for payments made to correct operational errors for which they have actual legal liability, even in the absence of lawsuits or other "claims" being made against them. The coverage does not, however, extend to any payments made by advisers as a business accommodation, to avoid reputational damage, or for any other reason apart from their own legal liability. The coverage typically requires insured advisers to obtain advance consent from their insurers before making, or committing to make, any such payments. Costs of correction coverage is standard in ICI Mutual's D&O/E&O policy.

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For a more complete discussion of basic D&O/E&O policy concepts and coverage issues, as well as factors to consider when structuring an insurance program, see ICI Mutual's 2009 guide to *Mutual Fund D&O/E&O Insurance.*

Special Challenges of Managing Private Accounts

Various factors contribute to the complexity of managing operational risks in the private advisory area: the sheer number of individual accounts managed by many advisers; the variety of investment approaches that may be involved in managing these accounts; the nature of the client relationship involved (e.g., individual, institutional and/or sub-advisory); and the sometimes competing internal priorities of advisory personnel.

Number of Accounts

Private account management often takes place on a dramatically different scale than fund management. There are only a limited number of mutual fund complexes with over one hundred funds, but it is not unusual for a single investment adviser to manage hundreds, or sometimes even thousands, of private accounts. Indeed, some advisers reportedly manage over 25,000 private accounts. Even advisers who seek to standardize contract terms and conditions among private accounts will typically find it necessary to accept variations in contract terms and conditions as among categories of private accounts, and perhaps even as among private accounts within a given category. Simply managing and monitoring the documentation and related client information for a large number of private accounts can pose an operational challenge for an adviser and require a substantial commitment of resources.

Variety of Investment Approaches

Private accounts are not subject to the same strict regulatory requirements regarding portfolio diversification and liquidity and limits on the use of leverage that are imposed on mutual funds. For these and other reasons, private accounts often have more flexibility and freedom regarding investment options and approaches, and it is not uncommon for advisers to

Standard vs. Non-Standard Investment Guidelines

Many advisers seek to utilize "standard" investment guidelines for private accounts wherever possible, in order to manage and reduce (1) the operational and compliance burdens associated with implementing and monitoring disparate guidelines, and (2) the risk of ambiguities or omissions in guidelines applicable to individual clients. While the number of "standard" guidelines may vary from firm to firm, a number of advisers report that they utilize fewer than 20 sets of such guidelines in their private advisory operations.

Some advisers permit use of "non-standard" guidelines (either in addition to or in lieu of "standard" guidelines), in order to address individualized investment goals and circumstances of private advisory clients. In determining whether to permit use of "non-standard" guidelines in a particular case, such advisers often weigh the potential for increased operational and compliance risks against the anticipated benefits of the client relationship.

Regardless of whether private account guidelines are "standard" or "non-standard," it is important for advisers to seek to ensure that they are complete, reflect the client's intentions, and are well understood by the advisory personnel tasked with servicing the affected account(s). To that end, advisers may want to routinely compare non-standard guidelines with standard guidelines to ensure that the non-standard guidelines – which are usually provided by the client – address all of the core concepts in the standard guidelines.

employ a wide array of investment techniques and instruments in managing them. Thus, for example, private clients may (1) ask or require advisers to manage their accounts using new investment products and/or evolving or atypical strategies, (2) impose individualized investment restrictions on management of their accounts (e.g., prohibitions on "sin" stocks, or on investments in the Sudan or Iran), and/or (3) establish special "non-investment" instructions (e.g., deadlines for "full investment," requirements regarding timing of liquidations or cash payments). As a result, private account investment guidelines (and related restrictions) can be complex and place additional demands on both operational and investment personnel to ensure full compliance.

Nature of Client Relationship

Private clients may include individuals (both small investors and high net worth individuals), public and private institutions (e.g., corporations, retirement plans, schools, municipalities, state entities), issuers of specialized structured products (e.g., collateralized debt obligations, collateralized loan obligations), or even other investment advisers. Different clients bring different needs and expectations, and may present different operational challenges as well. For example:

- advisers who provide services to individuals may find that communications (e.g., seeking clarification or an update of investment guidelines) become more challenging over time with certain long-term clients, as some clients, as they age, may become less willing or able to make decisions or take action on their accounts;

- advisers who provide services to retirement plans must be cognizant of and comply with a host of federal and state law requirements designed to protect plan participants and beneficiaries;[2]

New Investment Products and Strategies

The introduction of "new" investment products and strategies may increase an adviser's risk of operational errors. Regardless of whether the activity is new to the industry at large or simply involves a line of business that is new to a particular adviser, it is important that the risk parameters and operational requirements of new products and strategies be fully appreciated by key individuals within the advisory firm.

Many advisers formally or informally prohibit portfolio managers from investing in new securities or using new investment techniques without prior approval of management. Others impose limits on new securities and/or techniques until they have been appropriately vetted within the advisory firm. Soliciting input from all affected areas of the firm (e.g., trading, settlement, legal and compliance, accounting) on (1) potential operational issues associated with the proposed new activity, and (2) techniques for addressing those issues (e.g., new internal controls, automated systems upgrades) prior to the use of a new product or strategy in a private account can assist in managing the risk of operational errors.*

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* Moreover, advisory firms that elect to use the CFA Institute's Global Investment Performance Standards ("GIPS") to quantify and present their investment performance may wish to consider the potential impact of any proposed new investment activity on their composite construction in order to avoid running afoul of GIPS and, hence, the SEC (e.g., a false claim of GIPS compliance may be cited by SEC examiners as a misrepresentation of performance). *See* CFA Institute, GIPS Standards Today 17 (2010), http://www.gipsstandards.org/resources/pdf/gips_today.pdf (discussing regulators awareness of GIPS compliance); *see also* Secs. & Exch, Comm'n, ComplianceAlert (June 2007), http://www.sec.gov/about/offices/ocie/complialert.htm.

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[2] Separate and apart from any legal and compliance risks associated with the federal securities laws, advisers that operate in the retirement plan arena face specialized risks that derive in large part from the federal Employee Retirement Income Security Act of 1974 ("ERISA"). ERISA imposes complex obligations and prohibitions on a broad array of entities and individuals associated with retirement plans and retirement assets, and the potential exposure created by ERISA for violating these obligations and prohibitions can be substantial. For more information about ERISA-related risks and exposures, see ICI Mutual's 2010 guide to *ERISA Liability*.

- advisers who provide services to municipalities or state entities must often navigate rigorous and highly scrutinized public plan RFP (request for proposal) processes (which may include on-site due diligence visits and detailed questionnaires), as well as comply with heightened reporting requirements;[3]

- advisers who service other advisers must typically coordinate with and report to client advisory firms that may have very different operational systems and compliance philosophies; and

- advisers who provide services to international clients may need to take into account differences in language and/or business customs when setting client expectations and drafting contract provisions.

Competing Internal Priorities

Private account management necessarily involves personnel from many different areas of an advisory firm (e.g., marketing and sales, client services, portfolio management, compliance, legal, risk management), and multiple parties may have a stake in the success of an adviser's private advisory business. Each of these "internal stakeholders" has its own, sometimes competing, priorities relative to servicing the private account. Marketing and sales personnel may be focused primarily on bringing in new business, maintaining current accounts, and responding to client requests in a timely fashion. Portfolio management personnel may be focused primarily on actual investment decisions, trading, and performance issues. Compliance, legal and risk management personnel may be focused primarily on establishing policies and procedures and monitoring internal controls designed to address various key business risks (e.g., litigation, regulatory action, fraud loss, reputational damage). The involvement of multiple stakeholders within the advisory firm requires coordination and communication between and among them, and may also raise the issue of which of them should be viewed as having ultimate responsibility for decision-making relative to private accounts.

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[3] In addition, advisers that manage public pension plan assets and similar government investment accounts must comply with new rule 206(4)-5 under the Investment Advisers Act of 1940, adopted by the U.S. Securities and Exchange Commission ("SEC") in order to curtail so-called "pay-to-play" practices by advisers (i.e., making campaign contributions and related payments to elected officials in order to influence the awarding of management contracts). *See* Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 3043 (July 1, 2010), http://www.sec.gov/rules/final/2010/ia-3043.pdf (adopting release).

Common Types of Operational Errors and Oversights

Given the complexities inherent in the management of private accounts, it is not surprising that operational errors and oversights periodically occur, and that these errors and oversights can in some cases result in significant liability exposures for advisers, particularly during periods of market volatility.

Common types of operational errors and oversights include failures to follow investment guidelines and special client instructions, errors in effecting trades, and errors in processing corporate actions.

Failures to Follow Investment Guidelines and Special Client Instructions

Selecting securities for client accounts is, of course, at the heart of the investment management process. The portfolio manager, with assistance from research assistants and others, typically researches and evaluates securities that are purchase or sale candidates. However, a portfolio manager's investment decisions are often subject to constraints that are separate and apart from pure investment judgments.

FAILURES TO FOLLOW INVESTMENT GUIDELINES

Investment decisions must comply with all relevant investment guidelines or restrictions applicable to the client account, including any guidelines or restrictions imposed by federal, state or local law or regulation, or by the terms of the client advisory contract itself. ICI Mutual's claims experience evidences that many private advisory losses arise from failures by advisory personnel to consider and/or appreciate such guidelines and restrictions fully before engaging in securities transactions. Examples include:

- ***Violation of Investment Restriction on Insurance Stocks:*** A portfolio manager orally directed an "across the board" purchase of insurance stock for his managed accounts, notwithstanding that several accounts had restrictions on the purchase of insurance stocks. The portfolio manager's assistant, also unaware of the restrictions, purchased the insurance stock for all accounts, including the accounts subject to the restriction. Loss to Adviser: $3.1 million.[4]

- ***Purchase of Ineligible Securities:*** An adviser purchased assets that were not "eligible securities" under collateral management agreements with two issuers of collateralized debt obligations. Loss to Adviser: Approximately $5.6 million.

- ***Violation of Investment Restriction on Foreign Securities:*** Over a two and one-half year period, a portfolio manager for a pension and retirement fund account established a number of positions in securities issued by foreign issuers and in American Depositary Receipts ("ADRs"), notwithstanding that the advisory agreement prohibited investments in foreign securities, including ADRs. The portfolio manager was not aware that the advisory agreement prohibited such investments, and could not recall whether he had

[4] Where this study uses the phrase, "Loss to Adviser," the associated dollar figure is a gross loss amount and is not adjusted for any insurance proceeds or other recovery by the adviser.

reviewed the advisory agreement. Loss to Adviser: Over $500,000.

- ***Violation of Client Restriction on Derivatives:*** A portfolio manager for a local school board advisory client invested a significant percentage of the client's assets in derivative instruments, in violation of the client's established investment restrictions, and notwithstanding a state regulation that purportedly "capped" the investment return that school boards could obtain without severe tax consequences (which effectively removed the "upside" potential of the investment). Loss to Adviser: More than $600,000.

FAILURES TO FOLLOW SPECIAL CLIENT INSTRUCTIONS

Investment decisions must also comply with any special "non-investment" instructions that may be applicable to a particular advisory account (e.g., client-directed deadlines for liquidations). Examples of private advisory losses traceable to failures to follow such instructions include:

- ***Failure to Timely Liquidate Holdings:*** A portfolio management assistant misunderstood an internal communication regarding a client's email instructions to terminate and liquidate certain accounts immediately, resulting in a delay in effecting the liquidations. Loss to Adviser: $1.8 million.

- ***Failure to Meet Client Deadlines:*** An adviser's investment agreements with private accounts left discretion to the adviser to dispose of the accounts' large stock positions in an orderly manner, but specified maximum time periods for effecting such liquidations. The adviser had no formal process to monitor these deadlines or to seek client approval for any extensions that might be advisable. As a result, in certain instances, the adviser failed to liquidate the positions within the requisite time periods. Loss to Adviser: Approximately $1.4 million.

Errors in Effecting Trades

Trades in securities that are otherwise eligible for purchase or sale may be inaccurately *executed* as a result of errors or mistakes by traders, portfolio managers or other personnel. Typical trading errors include: (1) purchases or sales being made of a greater or lesser number of shares than intended, (2) purchases being made instead of sales, or vice versa, and (3) purchases or sales being made of the wrong security. Examples of trading errors include:

- ***Oversale of Portfolio Securities:*** In advance of a regularly scheduled rebalancing of portfolio securities held by a client account, an adviser was notified that a net portfolio redemption would be required in the amount of approximately $77 *thousand*. The portfolio manager misread the notice and sold almost $77 *million* of portfolio securities to meet the anticipated redemption request. Loss to Adviser: $1.1 million.

- ***Erroneous Sale of Eligible Security:*** The investment management agreements for two private accounts prohibited the accounts from holding over-the-counter ("OTC") securities. The portfolio manager mistook an eligible portfolio security for a prohibited OTC security and sold the eligible security out of the private accounts. Loss to Adviser: Over $2 million.

- ***Trader Exceeds Authority:*** Absent clear communication between a portfolio manager and a trader regarding limits on the trader's authority to purchase "long" stock index futures for private accounts, the trader exceeded the amounts previously authorized by the adviser's investment committee. Loss to Adviser: $100,000.

- ***Failure to Process Transaction Instructions:*** Advisory personnel failed to timely act upon requests received to effect certain investment transactions on behalf of a group of clients. Loss to Adviser: Over $4 million.

Errors in Processing Corporate Actions

A significant number of reported costs of correction claims have involved errors made by advisers, acting for private accounts, in processing tender and exchange offers, rights offerings, class action settlement opportunities and other "corporate actions" requests from issuers of portfolio securities.[5] Examples of corporate action claims include:

- ***Oversubscription to Rights Offering:*** A portfolio manager, acting on behalf of a private account, mistakenly subscribed "fully," rather than "partially," to a rights offering by a portfolio issuer. As a result of the account's receipt of the issuer's new shares, the account's position in the issuer exceeded both the account's own internal investment guidelines and statutory investment restrictions. Loss to Adviser: Approximately $1.15 million.

- ***Misunderstanding of Tender Offer Terms:*** A portfolio manager erroneously elected to take "no action" in response to a tender offer for bonds based on incorrect information about the terms of the offer from the adviser's corporate actions department. Loss to Adviser: Approximately $2.1 million.

- ***Errors in Tendering Shares:*** Advisory personnel mishandled the processing of client account responses to a "Dutch auction" tender offer by a portfolio issuer, which caused losses to four private accounts. Notwithstanding the portfolio manager's email directive for shares to be tendered "unconditionally," the portfolio administrators for three accounts directed the relevant custodians to tender the accounts' shares "conditionally." The portfolio administrator for a fourth account failed to respond to the offer at all. The offer was ultimately oversubscribed, and as a result, none of the shares tendered by the accounts was accepted for repurchase. Loss to Adviser: $2.9 million.

- ***Failure to Respond to Corporate Event Request:*** Adviser inadvertently failed to respond to a corporate action request with respect to some (but not all) shares of the issuer held by the adviser's clients. Loss to Adviser: $200,000.

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[5] The term "corporate actions" refers to various types of actions, taken by securities issuers in their corporate capacities, that may have economic impacts on the holders of the issuers' securities. Corporate actions can be initiated by both domestic and foreign issuers, and can affect both equity and debt securities. It has been ICI Mutual's experience that insurance claims typically arise from the mishandling of so-called "voluntary" corporate actions (e.g.,. issuer tender offers, exchange offers, rights offerings), where the holder of the affected security has a *choice* regarding whether to participate in the proposed action, and under which the holder must *respond* within a specified period if the holder elects to participate. For a more complete discussion of operational risks and procedures in processing corporate actions, see ICI Mutual's 2001 study on *Managing Risk in Processing Corporate Actions.*

Recurring Themes in Private Advisory Claims

Private advisory losses can frequently be traced to human errors or oversights (simple mistakes) coupled with systemic weaknesses or "gaps" in particular procedures or controls. That being said, a review of private advisory claims (some of which are referenced above) reveals certain major recurring causative themes, including: (1) incomplete, improper or ambiguous documentation, (2) poor internal communication and/or reporting, and (3) overreliance on automated compliance systems. Less common, but still important, causative themes include changes in key personnel and inaccurate data entry.

Incomplete, Improper or Ambiguous Documentation

Incomplete, improper or ambiguous documentation has been an underlying causative theme in a number of private advisory claims. Examples include:

- ***Inconsistent Contract Terms:*** Account documents for three separate accounts for a single sub-advisory client used different language to express a common restriction on equity holdings. When a conversion event (i.e., a portfolio security converted from a fixed income to an equity security) resulted in a purported violation of account guidelines, protracted negotiations with the client regarding interpretation of the guidelines resulted in a several-month delay in correcting the error and additional losses to the adviser. Loss to Adviser: Approximately $650,000.

- ***No Explicit Provisions for Account Termination:*** Neither the investment advisory agreement nor the investment guidelines for an institutional private client (a university foundation) set forth specific account termination or liquidation procedures. When the client submitted its request to terminate and liquidate certain accounts via email, the fixed income holdings were liquidated immediately. However, liquidation of the equity holdings was delayed because a portfolio assistant in a different investment group mistakenly waited for further written instructions from the client to proceed. The delay caused significant additional losses to the accounts as the value of the equity securities subsequently declined. Loss to Adviser: $1.8 million.

- ***Failure to Properly Record a Debt Security:*** A portfolio manager ordered total liquidation of certain debt securities. However, a portion of the debt securities had been incorrectly identified and recorded as a "bridge loan" and was not properly reflected in the account portfolios. As a result, only a partial liquidation was made; the portion of the securities recorded as a "bridge loan" remained in the accounts until the position was discovered and sold approximately four months later. Loss to Adviser: $2.8 million.

Poor Internal Communication and/or Reporting

Poor internal communication and/or reporting can exacerbate an error situation and prevent timely response. Examples include:

- ***Failure to Properly Report an Error to Compliance:*** A portfolio manager unilaterally attempted to remedy a (mistakenly) suspected trading error in two private accounts without properly notifying the compliance department. As a result, the compliance department was not able to determine whether an error had actually occurred *prior* to any corrective action being taken, as required by the adviser's trade error policy. In fact, there was no trading error in the first instance and the portfolio manager's unilateral "fix" caused the private accounts to deviate from the applicable investment model. Loss to Adviser: Over $2 million.

- ***Lapses in Communication:*** Ineffective communication (including delayed responses to emails and voicemails) between an adviser and a third-party manager relative to portfolio discrepancies increased the time required to discover and respond to an error in adjusting certain asset allocation models. Loss to Adviser: Approximately $4.2 million.

Overreliance on Automated Compliance Systems

Overreliance by portfolio managers and other advisory personnel on automated software systems to prevent errors and oversights in the portfolio management process has been a major recurring causative theme in private advisory losses. Often, automated compliance systems are unable to detect certain errors, either because of improper coding of investment restrictions (or other information) or because the system simply cannot track a particular type of security or transaction. Moreover, without sufficient manual oversight or secondary reviews, the discovery and resolution of the resulting errors can be substantially delayed. Examples include:

- ***Error in Coding:*** In reviewing a new account's governing documents, an employee failed to program one of the account's multiple investment restrictions into the adviser's front-end compliance system. Moreover, the adviser lacked procedures for having the employee's coding work reviewed by a second employee or supervisor. As a result, the error remained undiscovered until after several ineligible securities purchased for the account had declined significantly in value. Loss to Adviser: Approximately $5.4 million.

- ***Failure to Input New Restrictions:*** Advisory staff properly coded the *original* set of restrictions for a private account but failed to code *amended* restrictions. Accordingly, the adviser continued to hedge foreign currency after the investment guidelines had been amended to prohibit such hedging. Loss to Adviser: $3.5 million.

- ***Inability to Monitor Certain Activity:*** An adviser's compliance system did not track conversion events. Consequently, a debt-to-equity conversion of a portfolio security resulted in a violation of a prohibition against holding equity securities. Loss to Adviser: Approximately $650,000.

- ***No Warnings Given for Large Sales:*** An adviser's pre-trade compliance system did not provide advance warnings of *sales* (as opposed to *purchases*) exceeding 5% of portfolio net assets, and the adviser's procedures did not require a second employee or supervisor to review large sale orders. As a result, an errant order for a sale of securities (where the dollar value of the total order was off by factor of 1000) was not flagged or subject to secondary review and was executed. Loss to Adviser: $1.1 million.

Other Themes

KEY PERSONNEL CHANGES

Changes in key personnel have been a common denominator in at least two private advisory losses noticed to ICI Mutual. The departure of a portfolio manager (in one case) and the death of the chief compliance officer (in another) appear to have blurred a sense of responsibility and/or awareness regarding applicable restrictions and proper procedures.

INACCURATE DATA ENTRY

Inaccurate data entry can lead to a variety of operational errors, separate and apart from those related to automated compliance systems (discussed above). For example, in one loss noticed to ICI Mutual, inaccurate data entry caused an adviser to make errors in preparing certain performance data for an advisory client. Specifically, personnel at the adviser incorrectly input performance data for one month (i.e., a negative percentage was inadvertently keyed in as a positive percentage) resulting in an overstatement of performance. The error went undiscovered for over three years.

Risk Management Techniques

Advisers use a wide variety of techniques to mitigate their risk of loss from operational errors and oversights associated with private account management. There is no "silver bullet" set of best practices applicable to all advisory firms. That being said, a review of claims and interviews with industry experts suggests that effective risk management programs, despite varying in their particulars, tend to share a common focus on three areas: (1) enhancing documentation and contract management;[6] (2) improving coordination and communication; and (3) ensuring comprehensive monitoring and oversight.

Enhancing Documentation and Contract Management

INITIAL REVIEW AND APPROVAL OF PRIVATE ADVISORY CONTRACTS

Given the importance of complete and accurate documentation to the management of operational risks in the private account arena, advisers typically focus significant effort on ensuring that (1) the description of investment guidelines and restrictions contained in the advisory contract (and other client documents) is fully consistent with the client's expectations and the firm's actual portfolio management practices, and (2) any special terms or conditions governing the advisory relationship are identified and appropriately described and documented.

[6] In addition to reducing the risk of operational errors, a focus on properly constructed documentation for private accounts helps to ensure the existence of a contemporaneous, accurate, and unambiguous record, in the event that there is a dispute with an advisory client.

Focusing on the Front End

Some advisory firms have established distinct "intake" processes for vetting new clients and advisory arrangements. These firms may prohibit any investment activity until the intake process is complete and the new account terms have been formally approved and documented. Such approval may be conditioned on all affected departments of the advisory firm (e.g., trading, accounting, compliance) confirming their ability to properly handle the proposed new account/client. At some advisers, a dedicated team of staff oversees the intake process and shepherds documents through the various departmental reviews. Other advisers rely on staff in existing departments (often legal or compliance) to manage the process.

Establishing and maintaining a robust intake process for new advisory clients helps to ensure that:

1. the appropriate operational and management personnel are in a position to evaluate – fully and in advance of the account activation – relevant investment, legal, compliance and other implications of a particular private advisory arrangement;

2. advisory contract terms are clear and terminology uniform (e.g., treatment of split bond ratings or gradations in bond ratings, or definitions of terms such as "derivatives" and "foreign securities");

3. the competing interests (and priorities) of participants in the private advisory process (whether the interests of the adviser vis-à-vis its client, or of advisory personnel vis-à-vis one another) are recognized and duly considered;

4. actual portfolio management decisions for the private account are made in a deliberate manner and in accordance with the pre-established and fully documented investment guidelines and restrictions; and

5. new investment products, as well as evolving or atypical investment strategies, that may raise compliance or operational concerns are detected and are brought promptly to the attention of appropriate supervisory personnel at the adviser.

Such special terms and conditions may include, by way of example: when a new account must be fully invested; how and when to rebalance the private account in light of cash flow; when to start the performance clock; how compliance with certain client-directed investment restrictions will be achieved (e.g., use of a subscription service to monitor for investments in Sudan or Iran); and who has responsibility for certain reporting and filing obligations (e.g., Form 13F, responses to corporate or class actions).

It is common for legal and compliance personnel to be involved in reviewing new private advisory contracts (and other client documents). Advisers also frequently require portfolio management, client services and operations personnel to participate in the review of the account documentation and terms, to ensure that they are all "on the same page" regarding relevant issues and obligations.

To ensure a thorough vetting and appreciation of the terms and conditions of new accounts, advisers often employ detailed checklists as part of the review process. These checklists may or may not be customized for certain types of clients or particular investement strategies. In some advisory firms, different departments may each develop their own checklists, focused on different aspects of the client transaction.

Some advisers choose to create a library of pre-approved model forms and contracts as a way to promote consistency in private account documentation and limit errors and omissions in the drafting process. Any variations or modifications to the model forms and contracts are subject to a heightened level of scrutiny.

DOCUMENTATION OF CONTRACT AMENDMENTS AND UPDATES

Just as with initial advisory contracts, advisers frequently seek to ensure that all contract amendments and other updates (e.g., new client contact information, changes in financial condition) are fully reviewed, documented and communicated in a timely manner to all relevant advisory personnel. Advisers may employ a "routing sheet" approach whereby contract amendments and other account updates follow a prescribed route through various departments at the adviser (typically the same departments involved in the initial review process). Evidence of review and approval (i.e., formal sign-off) may be required for the materials to move along the route to the next department, with implementation of contract amendments occurring only after all departmental sign-offs are received.

Failure to appropriately document changes to existing client guidelines and restrictions often contributes to operational errors. Changes made through oral discussions with clients or as a result of custom and practice are particularly problematic. Where, for example, a portfolio manager communicates directly with a private advisory client in person or by telephone, it is important to establish a process whereby any and all changes to investment advisory guidelines and restrictions are reflected in an amended contract or otherwise documented in writing. Similarly, where there are direct electronic communications (i.e., via email or text messaging) with a client, it is important to establish a process whereby those communications are captured, formally documented and maintained as part of the official client file.

As part of their risk management efforts, advisers may also wish to review their document management programs (i.e., processes and procedures for filing and storing business documents, including client files), to ensure that appropriate personnel have access to complete and current (i.e., updated) private advisory contracts and related documents. Establishing a centralized electronic repository for client files and master documents, with proper access controls, may help reduce the risk of advisory personnel referencing outdated or incomplete versions of advisory contracts and related documents.

Special Role of the Portfolio Manager in the Risk Management Process

Portfolio managers play a critical role in the risk management process for private accounts, especially with respect to ensuring compliance with investment mandates. Many firms require portfolio managers (or their representatives) to periodically review investment guidelines and restrictions with each private client to help ensure that the investment mandates continue to be appropriate to the client's needs and that there is common understanding of any special terms or obligations. Such periodic reviews also help to keep portfolio managers current and up-to-date on individual account mandates and terms, and thereby create an important second line of defense against violations that might otherwise escape detection by customary compliance testing or screening.

The frequency of such reviews (e.g., quarterly, semi-annually, annually) may vary by adviser and, sometimes, by the nature and size of the client. Some advisers require portfolio managers to provide periodic attestations (e.g., quarterly, annually) stating that the portfolio transactions for a particular account were consistent with the investment guidelines and restrictions for the period.

A team portfolio management approach can increase the number of "eyes" watching an account, and may therefore assist in protecting against operational errors and oversights. Firms that use sole portfolio managers may seek to obtain similar protections by, for example, ensuring that the activities of the portfolio managers are thoroughly understood and reviewed by other persons who are themselves knowledgeable about the private accounts, or by instituting other checks and balances into their oversight activities.

INCORPORATION BY REFERENCE OF DOCUMENTS

Incorporation by reference of external documents into advisory contracts (e.g., state statutes or "global" pension plan guidelines) can create potential conflicts between the terms of the contracts and those of the external documents. Moreover, even where terms are in accord at the inception of the advisory arrangement, the substance of the external documents may change over time, creating subsequent conflicts and/or new obligations for the adviser. Absent a process for monitoring changes in these external documents, changes in terms may go undetected by the adviser, increasing the risks of non-compliance and operational errors.

Accordingly, some advisers seek to prohibit or limit the incorporation by reference (or attachment) of external documents to their private advisory contracts. Where that is not possible, some advisers seek to put the onus for reporting material changes in external documents explicitly on the advisory client, via contract provision. Other advisers rely on third-party service providers to monitor and flag relevant changes in statutes and regulations. In addition, where practicable, advisers may require current copies of all external documents to be provided for their files.

WRITTEN COMPLIANCE MATERIALS

In addition to client-specific documents (e.g., private advisory contracts), most advisory firms have developed written compliance manuals that are updated on a regular basis. Some firms have developed a handbook for each investment product they offer, which provides a single source for all investment limitations and other compliance matters relating to a specific product or technique. For many complexes, the process of developing and updating written compliance materials is itself a useful exercise, as it necessarily involves analysis and consideration of what limits and restrictions are (or are not) appropriate and workable, taking into account changes in the firm's business model as well as any industry or regulatory developments.

Improving Communication and Coordination

Advisers should encourage clear, concise, timely and accurate oral and written communication between advisory personnel and private advisory clients, as well as between and among advisory personnel themselves. Communication lapses between portfolio managers and the individuals with whom they interact on a daily basis, such as traders and legal and compliance staff, may contribute to operational errors and investment management losses. Moreover, once errors occur, proper and timely reporting of the errors and escalation of the relevant risk management issues to the attention of senior management are necessary, both to address the errors themselves, and to assess whether control and compliance enhancements may be warranted.

Multiple Offices

Where an adviser maintains multiple offices, special attention is often required to ensure appropriate coordination and communication among personnel. Different offices may handle the same or similar issues in different ways, and terminology, custom and practice may vary by locale. This is particularly relevant when an adviser has expanded through acquisitions or mergers, bringing together groups with distinct operational histories and compliance programs.

ENSURING UNIFORM TERMINOLOGY

Miscommunications may arise because portfolio managers and other advisory personnel do not always "speak the same language" (e.g., they may use different terms or concepts when describing or discussing the same issue or problem). In particular, there may be material differences in how securities are defined and/or classified by different groups. For example, criteria used to define a "foreign security" may include the security's primary trading market, pricing currency, place of incorporation and/or place of principal operations; similarly, derivatives and new investment products can be challenging to classify (e.g., as equities or fixed income securities, or as to the identity of the "issuer").

Effective risk management programs seek to encourage uniform definitions and classifications to avoid investment compliance violations. Some advisers rely on independent third-party sources for classifications of securities and strictly limit the ability of portfolio managers (and other advisory personnel) to override these classifications. Others have established standing committees to make firm-wide determinations and to approve any requests for changes to definitions and classifications. With respect to client communications, many advisers require key terms and definitions (especially as they relate to compliance with investment guidelines and restrictions) to be explicitly set out in writing in the advisory contract (or supporting materials), in order to avoid potential conflicts or misunderstandings.

ERROR DETECTION AND REPORTING

It is unrealistic to expect any compliance or risk management system to prevent all errors. Internal controls must be reasonably designed to protect the firm without stifling legitimate entrepreneurial activities. Given that errors cannot be fully prevented, early detection and reporting become key factors to enable timely and complete identification and remediation of errors. Moreover, systemic review and analysis of errors over time (including causation and resolution) facilitates enhancement of internal controls and compliance protocols.

The first step in the process is to confirm that errors are being properly identified. In addition to encouraging self-reporting of errors, advisers often conduct independent reviews of account documentation and transaction logs. For example, some advisers periodically review the firm's trade log to check for rebooked trades or canceled trades in order to determine whether trading errors occurred but were not reported.

It is also important that errors, once identified, be reported to and resolved at the correct level of the advisory firm. Some advisers have designated risk oversight committees which meet regularly (often monthly) or on an ad hoc basis to review error reports and make determinations about changes in compliance and/or risk management. These committees may be made up of representatives from various departments within the adviser. Some advisers have chosen to appoint a chief risk officer to lead their risk management efforts. Whatever their particular risk oversight structures, most advisers have established processes for how and when to involve legal, compliance and risk management personnel in reviewing and responding to operational errors. Typically, these departments have primary responsibility for maintaining and updating written policies and procedures.

In determining whether to escalate a potential risk issue related to an operational error to senior management for further consideration and response (including possible procedural changes or enhancements), advisers often consider various factors, including: the nature and size of the error; the cause(s) of the error; the financial impact of the error on the client or firm; the likelihood of recurrence; whether the error suggests a potential weakness or gap in existing controls; and the ability of the firm to take steps to prevent future errors of the same type.

CLARIFYING ROLES, RESPONSIBILITY AND INFORMATION FLOW

In any advisory firm, retaining knowledgeable, capable, and well-trained employees is a critical component of an effective risk management effort. In addition, having clearly defined roles and responsibilities and well-established systems and procedures for information flow are necessary to reduce the risk of operational errors due to miscommunications (among personnel as well as clients) or failures to properly coordinate amongst departments.

Portfolio Managers and Traders

Because operational errors in private accounts often involve errors in effecting trades, the relationship and interaction between portfolio managers and traders warrants special attention from a risk management perspective.

The level of authority given to portfolio managers relative to trading activity for client accounts varies among advisers. Some advisory firms seek to limit the risk of trading errors by completely separating the portfolio management and trading functions. Other firms allow portfolio managers to do limited trading (often in fixed income securities or international securities). At some firms (typically smaller firms with more limited staff), portfolio managers may execute trades on a more routine basis. To prevent or limit errors, especially where portfolio managers have authority to place trades for client accounts, many firms require someone other than the person placing the trade to review the trade, typically at settlement.

Advisers take a variety of steps to promote the accuracy of trade-related communications between portfolio managers and traders. Many advisory firms link portfolio managers and traders electronically. Others continue to rely on oral communications, but when doing so, often insist on independent confirmation of all trade orders, preferably in writing. Many firms also use other backup checks (particularly where trades are placed orally), such as requiring compliance limits to be noted on trade tickets, or portfolio managers to receive notification when approaching a compliance limit.

Because operational errors involving large trades can expose an adviser to larger potential losses, advisers often subject large trade orders to additional levels of scrutiny and controls.[7] Prior to executing a large block trade or a trade valued above a certain dollar amount, some advisers require peer review of the trade order (by another trader or portfolio manager), in order to confirm that the trade is consistent with (1) the client's investment guidelines and restrictions and (2) the instructions/intent of the portfolio manager. Such peer reviews may then be documented in trade logs, evidenced by the peer reviewer's initials. Peer reviewers may be required to refer to the source documents for the private account (e.g., advisory contract) before approving the trade to ensure the rationale for the trade is consistent with the investment guidelines and restrictions. Larger trades may also require email confirmation of the original order from the portfolio manager (or his/her representative) prior to execution.

Ensuring Comprehensive Compliance Monitoring and Oversight

Clear and comprehensive policies and procedures are critical to managing and reducing operational risks associated with private account management.[8] But it is likewise critical to monitor that these policies and procedures are being followed and that they are working as intended.

Effective compliance programs are often structured to include both micro and macro elements. A focus on micro elements helps to ensure that operational risks raised by the specific actions of individual employees (e.g., portfolio managers) are understood and, to the extent possible, reduced. A focus on macro elements helps to ensure that risks that arise from the firm's private advisory activities as a whole are appreciated at the organizational level, and that appropriate institutional resources are devoted to managing and reducing them.

At many firms, the compliance and monitoring functions are independent of portfolio/investment management. Where they are not, some firms use external sources to conduct periodic reviews of their compliance and monitoring activities. In addition, an advisory firm's accounting group may be incorporated into the monitoring process (e.g., fund accounting may monitor mechanical limits of automated systems and identify anomalies).

In monitoring private account business, advisers typically conduct a variety of reviews throughout the year. The types and timing (e.g., daily, weekly, monthly, quarterly) of reviews may vary depending upon assessments of risk to the organization and the level of controls and comfort that management believes should exist (i.e., individual entity risk tolerance). Reviews may involve inquiry and observation, as well as testing that is

[7] What is considered a "large trade" may vary depending on the nature of an adviser's business and/or type of private advisory client (e.g., retail or institutional).

[8] An adviser's policies and procedures and oversight practices should be designed to ensure day-to-day compliance at three levels: (1) with applicable laws and regulations; (2) with the adviser's contractual obligations to its clients; and (3) with the adviser's own internal business practices.

transactional, periodic and/or forensic in nature. Separate and apart from internal reviews, some advisers engage third parties (e.g., public accounting firms, compliance consultants) to conduct independent reviews of aspects of their private advisory business.

Types of Reviews

Examples of reviews conducted by advisers to ensure adherence to investment guidelines and restrictions applicable to private accounts include:

- review of post-trade investment compliance exception reports (summary of actual or potential investment compliance breaches)
- review of compliance rule override reports (number of overrides, rationale and authorization for overrides)
- review of portfolio and composite performance calculations and dispersion analyses to identify performance outliers and evaluate potential causes (e.g., client restrictions, timing of investment opportunities, account favoritism)
- review of trade error reports (nature and size of errors, timeliness of discovery, corrective actions, procedural enhancements)
- review of strategy reports prepared by senior management for specific investment mandates (e.g., domestic and international equities, fixed income)

SCREENING INPUTS AND OUTPUTS

Investment decisions often must be made and documented under severe time constraints. Simple administrative errors (e.g., incorrect instructions, calculation errors, improper data entry, misclassification of securities, miscoding) by advisory personnel can ultimately contribute to significant and costly operational errors. Screening the quality of data inputs and outputs is thus a critical aspect of compliance monitoring. While most experts believe it preferable to monitor data entry on as close to a "real time" basis as possible, such monitoring may not always be feasible. Advisers often conduct periodic and/or random reviews of trading logs to ensure accuracy, timeliness and completeness of recordkeeping (and associated data entry).

AUTOMATION AND THE HUMAN FACTOR

Compliance monitoring becomes particularly important for advisers managing private accounts with a variety of client-imposed investment restrictions. Compliance monitoring can be automated, manual or a combination of both.

While automated compliance systems often present operational challenges and are subject to substantive limitations, most advisory firms employ them in some form and view them as a worthwhile investment and important component of their larger risk management and compliance programs. Many firms also supplement their use of automated systems with other risk management measures, including manual checklists, approved lists of securities, and/or periodic compliance audits conducted by internal or external sources.

Advisers are increasingly using automated compliance systems to screen individual private account trades for compliance with investment guidelines and restrictions. Such automated screening of trades can be done before and/or after execution. Automated compliance systems can be commercial (either purchased off-the-shelf or customized by a third-party vendor) or proprietary (developed internally at the adviser). Some are primarily trading systems, while others incorporate additional compliance monitoring features (e.g., monitoring of code of ethics filings) and testing functions (e.g., testing account performance against the data feed for a selected benchmark).

In an automated front-end (or "pre-trade") compliance system, each security transaction is pre-screened against programmed investment criteria (based on the client's investment guidelines and restrictions). Potential alerts (or "red flags") are generated when a portfolio manager seeks to place a trade in potential violation of the investment criteria or other limitations (e.g., purchase of a prohibited security, a sale of shares not owned, a sale of shares in excess of current holdings). In some systems, portfolio managers may be permitted to override such alerts and enable trades, subject to additional review and authorization (e.g., by legal or compliance personnel, or, in some instances, by the private advisory clients themselves). Any such overrides should be well documented, evidencing reasons for the review and receipt of proper authorizations.

In an automated back-end (or "post-trade") compliance system, executed transactions are likewise screened against programmed investment criteria, but on an after-the-fact basis. Where potential violations are identified, portfolio managers, or other designated personnel, must review the trade to determine if the trade was permissible and, if not, whether corrective action is warranted. Legal and compliance personnel may be consulted in the process and required to authorize any corrective action.

The results of both pre- and post-trade reviews are often documented in so-called "exception reports." While such reports are typically generated at the end of the trading day or the next trading day (T+1), some systems permit firms to generate and review reports throughout the day. It is important to consider who ultimately receives and reviews exception reports, with some advisers providing for an escalating degree of review for exceptions based on severity.

There are practical challenges and limitations that must be acknowledged and addressed when using automated compliance systems (whether front-end or back-end). Certain types of securities (e.g., derivatives and new investment products), investment guidelines (e.g., fixed income), or events (e.g., security conversion or corporate action) may be more difficult to program in automated systems.

In addition, advisers must fully understand the default settings for their automated system and take those settings into account (or adjust them) when programming client guidelines and restrictions. For example, some automated systems may default to exclude consideration of open orders (i.e., orders placed but not filled by the broker/dealer) when screening new trade orders against portfolio concentration limits. This may result in an account's concentration limits being violated (without any pre-trade alert to the portfolio manager) if an additional trade order is placed without reference to the open order.

Controls Over Coding

Controls over coding are critical to the success of any automated compliance system. Because inaccurate or incomplete coding may allow errors to be made and go undetected, advisers consistently emphasize the importance of building redundancies (e.g., multiple checks and reviews of inputs, testing of trades) into the coding process.

Some advisers have established specialized coding teams to manage the coding process (i.e., how coding is done) and to establish controls to ensure the accuracy of coding (e.g., who reviews the coding and the frequency of reviews). Team members may focus on various aspects of the coding process, including daily monitoring, rule definition, and special projects.

To further verify the accuracy of coding over time, advisers may require portfolio managers to review complete print-outs of the coding for particular accounts for consistency with current investment guidelines and limitations. These comprehensive reviews may be done on a periodic basis (e.g., every 2-3 years).

Whenever coding errors or system problems are identified with respect to a particular private account, it is important to consider whether any other clients may have the same or similar issue.

Errors related to automated compliance systems (see discussion on pages 12-13) underscore the importance of ensuring that such systems are set up correctly in the first instance, that all relevant personnel understand the limitations of such systems (e.g., scope of system, coding limitations), and that portfolio managers do not substitute overreliance on such systems for an independent and thorough understanding of each account's applicable restrictions. It is important to recognize that some compliance functions cannot be reliably automated (because they are not codable or they are too expensive or time consuming to code). In such cases, it is particularly important for advisers to consider appropriate procedures for alternative/manual transaction reviews.

FORENSIC TESTING

Separate and apart from the contemporaneous review and approval of individual investment decisions, comprehensive (or so-called "forensic") testing of investment results can help to ensure compliance with private account guidelines and restrictions over time.[9] (Similarly, a review of trading activity across accounts during a sample period can help to identify patterns or trends with respect to trading errors and ensure that any such errors are promptly identified.) In recent years, forensic testing has emerged as an important mechanism for assessing whether an advisory firm's activities are consistent with its compliance policies and procedures. Moreover, the SEC staff has encouraged the use of forensic testing by advisers, especially as part of their annual compliance reviews.[10]

BUILDING BACKUPS AND REDUNDANCIES

Because there appears to be no single foolproof way to eliminate the risk of operational errors when managing private accounts, many advisers seek to reduce their risk by using backup systems and procedures in certain key areas (e.g., requiring written confirmations of oral orders from portfolio managers to traders, periodically verifying their pricing services' securities valuations with other pricing services). Independent or "secondary" reviews of key activities (i.e., reviews by someone other than the person taking the initial action) can be an effective and straightforward way to identify and correct potential errors in almost any process. One advisory firm colloquially refers to this risk management technique as the "Doer and Reviewer Approach."

Pricing Portfolio Securities

Once securities have been purchased and allocated to client accounts, they must be valued or "priced" properly and the prices must be accurately recorded in the adviser's books and records for purposes of calculating and reporting account values. Account values may be misstated because portfolio securities are incorrectly priced as a result of administrative errors in recording details of trades (e.g., amounts, CUSIP numbers), coupled with failures of backup procedures. If account values are not accurate, the portfolio manager will not have accurate information about positions held in client accounts, which may lead to further errors. Moreover, inaccurate account values may result in the miscalculation of any asset-based fees for the accounts.

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[9] "Forensic testing" generally refers to transactional or quality control testing that may assist in determining whether advisory firms' activities are consistent with their compliance policies and procedures. *See* Secs. & Exch. Comm'n, CCOutreach National Seminar: Forensic Measures for Funds and Advisers (Nov. 2007), http://www.sec.gov/info/cco/forensictesting.pdf (providing examples of forensic testing measures that may be used to assess compliance in various areas).

[10] *See Id.*

Other Techniques

TRAINING AND EDUCATION

Most advisers recognize that initial training and continuing education, whether formal or informal, are critical elements of their risk management programs, especially as their organizations grow and product offerings and investment techniques become more complex. This training and education may take place informally through "on the job" interactions or more formally through regular meetings, special presentations and workshops, or written communications. Training and education initiatives are often specifically designed to keep advisory personnel current on new private advisory activities and services and to help them to identify, understand and manage any resulting new risks to the firm. These initiatives also may be designed to address specific changes to internal policies and procedures (i.e., compliance updates) and regulatory or industry developments.

Effective training and education should emphasize not only what to do, but also why. To that end, advisers may wish to include real-life examples of common operational errors in their training materials and educational presentations, in order to highlight what can go wrong when policies and procedures are not followed.

FOCUSED RISK ASSESSMENTS

Some advisory firms conduct "focused" risk assessments with respect to particular areas or aspects of their private account business (e.g., marketing and business development, potential conflicts of interest, electronic communication and social media). The specific type and scope of assessment may depend on factors such as the nature of a firm's private accounts, changes in the firm's business model or structure, and/or regulatory initiatives. These special risk assessments may be done on a periodic or ad hoc basis.

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