ICI MUTUAL RISK MANAGEMENT STUDY

Investment Management Compliance Risks

A Study of Common Pitfalls and Risk Management Techniques

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Introduction and Executive Summary

Approximately two-thirds of all insurance losses paid by ICI Mutual during the past thirteen years relate to errors in investment management compliance. "Investment management" can be defined generally as the process by which an investment adviser buys and sells securities for client accounts. The key player in the investment management process obviously is the portfolio manager, but a variety of other persons are integral to the process, including analysts, traders, legal and compliance personnel, and accountants. "Investment management compliance" may be defined broadly as the process by which an investment management complex seeks to ensure that client accounts are managed in accordance with regulatory limitations, stated investment objectives, and client guidelines. Investment management compliance seeks to foresee and reduce the risk of both unintentional errors (i.e., mechanical errors or errors made in good faith) and intentional or quasi-intentional errors (i.e., errors based on questionable, reckless, or intentional conduct).

ICI Mutual has conducted a study on investment management compliance risks ("Study") that is designed to assist portfolio managers and management in their risk prevention efforts — portfolio managers because of the key role they play in preventing losses and management because it is in the best position to ensure that a complex devotes sufficient resources and attention to investment management compliance matters. The Study is designed to assist these individuals in:

- Appreciating the need to manage investment management compliance risk.
- Identifying the points in the investment management process at which losses are most likely to arise.

- Implementing risk management techniques — tailored to each complex's needs — to reduce the risk of losses.

The Study is not intended to and does not recommend any single structure or set of "best practices" to address investment management compliance risks. Given the diversity of the investment management industry, it is not practical or advisable to seek a "one size fits all" standard for behavior in this area. Effective risk management for a particular complex will depend upon many factors particular to that complex, including complex size, investment focus, nature of products offered, and overall compliance philosophy. Indeed, the Study suggests that while the compliance risks that complexes face generally are similar, how they seek to manage these risks varies substantially based on each complex's unique history, development, and culture.

The observations in the Study are derived from ICI Mutual's detailed interviews with selected insured complexes, from ICI Mutual's analysis of investment management compliance losses reported by insured complexes (many of which are not a matter of public record), and from ICI Mutual's analysis of publicly-reported losses sustained by non-insured complexes. The Study is divided into three sections:

Overview — presents general observations on investment management risk and a series of questions that insured complexes may wish to consider in conducting self-assessments of their investment management compliance risk efforts.

Key Functions and Risks — identifies what ICI Mutual believes are the most likely sources of significant claims within the six key activities in the investment management process: selection of securities, execution of orders, allocation of brokerage, allocation of securities to client accounts, pricing of portfolio securities, and disclosure. This section also discusses questions that complexes may wish to consider in seeking to mitigate compliance risks arising from these activities.

Management Oversight — discusses management's role in overseeing investment management compliance and how many complexes perform this function. This section also presents questions that complexes may wish to consider in structuring their oversight efforts.

Overview

The Study supports the following general observations regarding investment management compliance risk:

Investment Management Errors

Investment management errors can result in serious monetary, regulatory, and reputation costs.

Over the past thirteen years, errors in investment management — unintentional and intentional — account for losses paid by ICI Mutual to insured complexes exceeding $80 million. Nor are ICI Mutual insureds the only fund complexes to have sustained such losses, as is clear from a review of publicly-reported losses sustained by fund complexes not insured by ICI Mutual. Individual losses to complexes have ranged from $100,000 to more than $20 million. Some of these errors have generated shareholder litigation and regulatory actions by the Securities and Exchange Commission ("SEC") and other regulators.[1] In addition to investment advisers, named parties in these actions have included individual portfolio managers, chief investment officers, and other high-ranking personnel. Complexes have spent millions of dollars in legal and other fees in defending these lawsuits and regulatory actions. In some cases, the damage to reputation from these actions has contributed to a significant loss of existing and new business for the complex.

Errors That Cause Most Losses

Certain types of errors account for most investment management losses.

A review of the investment management claims received by ICI Mutual reveals that most losses relate to the following five areas: (1) introduction of new investment strategies and products, (2) communication lapses, (3) regulatory or client limits on investments, (4) administrative errors, and (5) intentional misconduct.

NEW INVESTMENT STRATEGIES AND PRODUCTS

The introduction of new investment strategies and products often is a significant source of new lawsuits or other claims. In some cases — such as claims arising from the use of new derivative instruments in the 1990s — the risk parameters of new strategies or products may not be fully appreciated by the industry at large. In other cases — such as claims involving a line of business new to a particular complex — the risk of new strategies or products, or the regulatory constraints applicable to them, may not be fully analyzed or understood by the individual complex or by key individuals within the complex. Examples of these types of losses include:

- *Derivatives and Foreign Investment Techniques*. In the 1990s, portfolio managers' use of new derivative instruments and foreign investment techniques produced a number of claims. The claims were often triggered by the failure of the instruments or techniques to perform as anticipated, or as disclosed in prospectuses or other public documents. ***Losses to Complexes: More than $25 million.***[2]

- *Insurance Diversification*: In operating a new fund created as an investment option for variable annuity contracts, a portfolio manager and relevant compliance personnel failed to appreciate the diversification requirements under the Internal Revenue Code. As a result, investments in U.S. Treasury securities were made by the fund in excess of the amounts permitted under the Code. ***Loss to Complex: More than $1 million.***

COMMUNICATION LAPSES

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 lead to investment management losses. Examples of these losses include:

- *Investments Inconsistent with Prospectus.* A portfolio manager invested fund assets in certain derivative instruments, notwithstanding a statement in the prospectus that the fund had "no current intention" of making such investments. Legal and compliance personnel responsible for making revisions to the prospectus language were not informed of the change in investment strategy. In addition to other findings, the chief investment officer of the firm was held liable for failure to supervise the activities of the portfolio manager. ***Loss to Complex: More than $20 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 complex's investment committee. ***Loss to Complex: $100,000.***

REGULATORY OR CLIENT LIMITS ON INVESTMENTS

A portfolio manager's investment decisions typically are subject to constraints that are separate and apart from investment judgments. These constraints may be imposed by federal, state or local law or regulation, the terms of disclosure documents or client advisory agreements, or other sources. Many investment management losses arise from a failure to consider and/or appreciate these constraints fully before investing. Examples of these types of losses include:

- *Violation of Legal Limits.* A portfolio manager purchased more than 10% of the shares of a foreign securities brokerage firm, in apparent violation of an SEC rule restricting a fund's holdings in securities-related issuers to 5% of the issuer's total equity securities. The manager mistakenly believed that the SEC rule did not apply to foreign broker-dealers. ***Loss to Complex: $450,000.***

- *Violation of Client Constraint.* A portfolio manager orally directed an "across the board" purchase of an 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 Complex: $3.1 million.***

- *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 alleged 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). State court litigation followed. ***Loss to Complex: More than $600,000.***

ADMINISTRATIVE ERRORS

Investment decisions often must be made and documented under severe time constraints. Simple administrative oversights by portfolio management personnel in decision-making and documentation underlie many claims reported to ICI Mutual. Examples of these types of losses include the following:

- *Incorrect Instructions*. A portfolio manager intended to reject a below-market tender offer for bonds, but inadvertently checked the "accept" box on the tender response form. By the time the error was discovered, it was too late to withdraw the tender. ***Loss to Complex: $750,000.***

- *Calculation Error*. In rebalancing a fund portfolio to mirror a model index, a portfolio manager committed an administrative error in preparing relevant spreadsheets, resulting in incorrect positions being established in hundreds of portfolio securities. ***Loss to Complex: $1.4 million.***

INTENTIONAL MISCONDUCT

The investment management industry has been relatively scandal-free. While no complex likes to consider the possibility that a trusted portfolio manager or other individual with significant responsibilities may engage in reckless or intentional misconduct, some of ICI Mutual's largest claims involve such allegations. Senior management is particularly at risk in these cases for "failure to supervise" charges, particularly if it appears that meaningful oversight might have prevented the misconduct. The SEC expects supervisors to respond vigorously to any indication of possible wrongdoing.

- *Misallocation of Profitable Trades*: A portfolio manager was charged with misallocating profitable futures trades between an in-house pension plan and managed funds, resulting in class action litigation and multiple regulatory investigations. Findings included failure to supervise liability. ***Loss to Complex: More than $10 million.***

- *Excessive Trading*. Portfolio managers and supervisory personnel were charged with failing to monitor or detect grossly excessive trading in futures by an employee to whom limited trading discretion had been granted, resulting in regulatory investigations. ***Loss to Complex: More than $20 million.***

Question Your Compliance Risk Efforts

As discussed below, complexes use a wide variety of techniques and procedures to reduce their risk of losses from investment management activities. While there is no "silver bullet" set of best practices that would be appropriate for all complexes, the Study suggests that effective compliance risk management efforts are grounded in an appreciation of the importance of the following three themes:

- Identifying and understanding the key risks a complex faces.

- Establishing a system of independent oversight, checks and balances, and written procedures.

- Retaining knowledgeable, capable, and well-trained employees.

Complexes may wish to consider the following general questions, among others, in reviewing their efforts to reduce investment management risk.

HOW DOES MANAGEMENT EXERCISE APPROPRIATE OVERSIGHT OF THE INVESTMENT MANAGEMENT COMPLIANCE RISK PROCESS?

- In addition to legal and regulatory concerns, common-sense business practice dictates that a complex should exercise appropriate supervisory oversight over the investment management compliance risk effort. In particular, management should seek to limit, to the maximum extent possible, a complex's exposure to those compliance risks that could have severe consequences to the financial health or reputation of the complex, i.e., "franchise risks."[3] Examples of franchise risks could include errors that result in substantial economic losses or errors that give rise to significant regulatory actions.

How management seeks to provide the appropriate oversight varies from complex to complex. Oversight may be provided by an individual or by a group. For complexes with a Chief Investment Officer ("CIO"), this function frequently is one of those assigned, in whole or in part, to the CIO. Management oversight of investment management compliance risks is discussed further below.

- As shown in recent SEC enforcement cases, regulators perceive that complexes have a formal hierarchy of management responsibilities (and this is the case whether or not such hierarchy in fact exists formally or informally within the complex).[4] This perception helps to explain the frequent "failure to supervise" charges brought against advisers and senior management in cases involving significant errors or questionable conduct in the investment management process.

- Effective evaluation and oversight of franchise risk, particularly risk associated with new and ongoing investment strategies and products, may require the attention of personnel with a background and expertise in investment management beyond that typically needed by personnel charged with day-to-day legal and compliance review of the portfolio management process.

- In light of the strong regulatory emphasis on the supervisory obligations of senior management and the franchise risk inherent in many aspects of the portfolio management process, many complexes devote significant resources seeking to minimize such risks.

- Oversight of the investment management process may lead to tensions within a complex, particularly with respect to a complex's entrepreneurial efforts and in complexes that may have a less formal organizational structure.

CAN YOU IMPROVE COMMUNICATIONS BETWEEN PORTFOLIO MANAGEMENT PERSONNEL AND OTHER DEPARTMENTS?

- In order to reduce the risk of losses due to communication failures, complexes may wish to review whether their systems and procedures — both formal and informal — are appropriately designed (1) to encourage frequent and substantive communication between portfolio managers and the individuals on whom they rely for assistance and counsel in completing portfolio management functions, and (2) to reduce the likelihood of ambiguities or misunderstandings in the course of such communications.

- In some cases miscommunications arise because portfolio managers and others do not always "speak the same language," i.e., they use different terms or concepts when describing or discussing the same issue or problem. Complexes should encourage clear, concise, and accurate oral and written communications about investment management compliance matters.

- Many complexes believe that formal communications between departments on compliance issues are less effective for portfolio managers than informal "on the job" interaction. A successful informal approach requires a highly responsive compliance effort. Complexes with successful informal approaches encourage strong day-to-day working relationships between portfolio managers and compliance.

DO YOU HAVE ADEQUATE SYSTEMS AND PROCEDURES TO PREVENT AND DETECT VIOLATIONS OF INVESTMENT GUIDELINES AND RESTRICTIONS?

- Many complexes understand that in an effective investment management compliance risk effort, “process” may be as important as “people.” Complexes may wish to review their systems and procedures, with an eye towards (1) training and continuous education for portfolio compliance personnel on relevant guidelines and restrictions, (2) improving the communication of changes in relevant guidelines and restrictions, (3) preventing violations of guidelines and restrictions through administrative oversight, and (4) monitoring, on as close to a “real time” basis as feasible, adherence to relevant guidelines and restrictions.

DO YOU HAVE/WOULD YOU BENEFIT FROM BACKUP SYSTEMS AND PROCEDURES?

- Because there appears to be no single fool-proof way to eliminate compliance risks, many complexes seek to reduce risks by using backup systems and procedures in certain areas (e.g., requiring written confirmation of oral orders from portfolio managers to traders, periodically verifying their pricing service’s securities valuations with another pricing service).

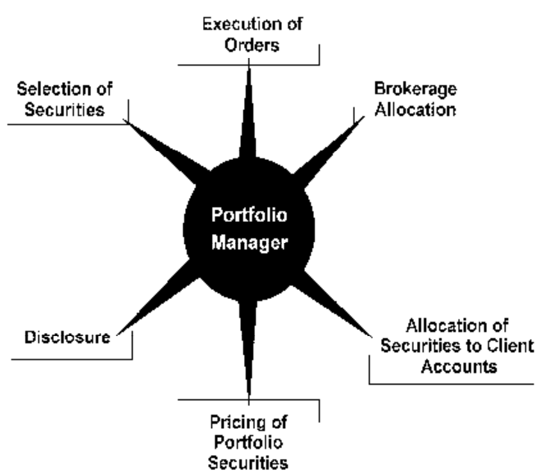
DO YOU EMPHASIZE STRICT ADHERENCE TO EXISTING PROCEDURES AND MONITOR THE ACTIVITIES OF PORTFOLIO MANAGEMENT PERSONNEL FOR COMPLIANCE WITH PROCEDURES?

- Establishing procedures is important in managing and reducing investment management compliance risks. It is equally important to emphasize the need to follow such procedures, and to monitor activities to ensure that procedures are being followed.

Key Investment Management Functions And Risks

Complexes structure their investment management processes differently, depending on size, investment style and philosophy, resources, and other factors. This section of the Study reviews the following six key activities in the investment management process that are common at all complexes: (1) selection of securities, (2) execution of orders, (3) allocation of brokerage, (4) allocation of securities to client accounts, (5) pricing of portfolio securities, and (6) disclosure relating to investment management matters. The portfolio manager plays a critical role in each of these areas.

Key Role of the Portfolio Manager in Investment Management Compliance



This section of the Study also identifies significant potential risks within each of these activities, with specific illustrations of how losses can arise. In addition, this part identifies, based on ICI Mutual's interviews with complexes and publicly-available information, various questions that complexes may wish to consider in seeking to reduce the risk of loss in each of these areas and techniques adopted by some complexes that may help reduce the risk of losses.

Selection of Securities

POTENTIAL AREAS OF RISK

Selecting securities for client accounts is, of course, the heart of the investment management process. The portfolio manager, with assistance from research assistants and others, typically researches and evaluates securities that are potential purchase or sale candidates. Any securities selected must be a permitted investment and must comply with any relevant investment guidelines or restrictions applicable to the client account.

Poor investment performance, by itself, should not be a basis for private or regulatory actions against complexes or portfolio managers, provided that adequate risk disclosure has been made to investors and the account has been managed in accordance with applicable guidelines.[5] Rather, the Study suggests that the most significant sources of risk in this area have involved (1) impermissible investments, (2) failure to comply with applicable limits imposed on otherwise permissible investments, (3) failure to fully analyze the risk parameters of new strategies or products, and (4) intentional misconduct.

Impermissible Investments: Particular investments by a portfolio manager for a managed fund or account may be prohibited by: (1) statute or regulation, (2) terms of a fund prospectus or other disclosure document, or (3) restrictions established by an advisory client or the complex itself.

- *Example — Advisory Contract Restriction.* 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." Although the complex's computerized systems might have detected the violation at the time of purchase, the restriction was improperly "coded" due to a data entry oversight. The portfolio manager was not aware that the advisory agreement prohibited such investments, and could not recall whether he had reviewed the advisory agreement. ***Loss to Complex: More than $500,000.***

- *Example — Regulatory Restriction.* An investment adviser to mutual funds, pension accounts, and a hedge fund caused the accounts to engage in cross trades that either did not comply fully with, or for the pension accounts were not permitted by, applicable regulatory requirements. The investment adviser mistakenly believed that the cross trades were permitted. The adviser, the portfolio manager, and the chief compliance officer of the complex were censured and were ordered to cease and desist from additional violations. ***Loss to Complex: Almost $7 million.***

Investments in Excess of Applicable Limits: Particular investments by a portfolio manager for a managed fund or account may exceed limits (e.g., percentage limits, quality limits, geographic limits) imposed by (1) statute or regulation, (2) the terms of a fund prospectus or other disclosure document, or (3) an advisory client or the complex itself.

- *Example — Purchase of Foreign Securities.* A portfolio manager purchased over 10% of the shares of a foreign securities brokerage firm, notwithstanding an applicable SEC rule that generally limits a fund to no more than 5% of such an issuer's total equity securities. Under the complex's procedures at the time, portfolio managers were responsible for identifying securities subject to the rule. The complex had previously held a training seminar and circulated a compliance memorandum covering the applicable restriction. Although the portfolio manager correctly identified the issuer as a foreign securities brokerage firm, the manager mistakenly believed that securities of foreign broker-dealers were not subject to the limits imposed by the rule. ***Loss to Complex: $450,000.***

Investments in Securities Without Fully Appreciating Risks: Particular investments by a portfolio manager may be made without a full understanding of the risks of the securities. The investments also may be inconsistent with the stated investment objectives of a managed fund or account, which may result in a breach of the adviser's fiduciary duty and violations of the antifraud and disclosure provisions of the federal securities laws.

- *Example — Purchase of "Stripped" Mortgage-Backed Securities."* A portfolio manager purchased "interest only" and "principal only" stripped mortgage-backed securities for a managed fund, despite the fact that the fund was marketed as a low-volatility investment and the fund's prospectus stated that the fund had no present intent to invest in such securities. When interest rates rose, the fund suffered significant losses. In the resulting SEC enforcement action, the adviser was cited for failure to supervise. ***Loss to Complex: More than $20 million.***

Intentional Misconduct: Particular investments by a portfolio manager may be part of a deliberate scheme involving misconduct.

- Example — Investments as Part of a Fraudulent Trading Strategy. A portfolio manager and trader placed purchase orders, shortly before the market close at the end of fiscal periods, in securities heavily owned by the manager's advisory clients, for the purpose of increasing the closing price of the securities. The strategy caused a short-term increase in the value of some advisory accounts, which was reflected in quarterly performance results. The strategy was not disclosed to clients or authorized under account investment guidelines. The adviser was cited for a failure to supervise. ***Loss to Complex: More than $200,000.***

GENERAL RISK MANAGEMENT TECHNIQUES

In addressing these risks, complexes may wish to consider the following questions, among others:

Written Policies: Does your complex have the need for formal, written policies that set forth investment objectives/policies, compliance restrictions, and risk limits for your investment products? Do you review and periodically update your written policies to reflect changing circumstances, new instruments, or other relevant developments and promptly circulate them to all affected parts of your complex? Policies regarding the investment objectives, restrictions, and risk limits of particular clients typically are set forth in prospectuses, SAIs, and advisory contracts. In addition to these client-specific documents, some complexes establish written policies on investment management compliance that provide for a complex-wide overview. For many complexes, the process of developing and updating written compliance policies itself is extremely useful because it necessarily involves analysis and consideration of what limits and restrictions are or are not appropriate.

Compliance Monitoring: What steps does your complex take to monitor compliance with investment limitations? Is the compliance monitoring function independent of portfolio management? If not, have you established adequate checks, balances, and controls? Many complexes use pre-trade or post-trade monitoring systems to review compliance with investment limitations, while others use random or other reviews of investment activity and portfolio holdings. Some complexes provide portfolio managers with a list identifying positions that may be approaching a compliance limitation (i.e., an "early warning"). Other complexes provide portfolio managers with "real time" information on their portfolios, including pending trades. In many cases, the complex's fund accounting group is incorporated into the monitoring process (e.g., fund accounting may monitor mechanical limits and identify anomalies). At most complexes, the compliance function is independent of portfolio management. Where it is not, the complex may use external sources to conduct periodic reviews of its compliance activities.

Automated Compliance Systems: Has your complex considered the use of automated compliance systems to alert portfolio managers and others to potential compliance risks before they arise (including "red flags" on potential compliance risks)? Many complexes have developed internally or purchased commercially front-end compliance systems (though most acknowledge the practical challenges and limitations of such systems). A number of complexes use a combination of front-end, end-of-day, and next day compliance monitoring systems. Systems at some complexes provide "red flags" when portfolio managers seek to place trades in potential violation of an investment limitation (e.g., sell shares not owned or sell shares in excess of current holdings). Some complexes provide for an escalating degree of review for exceptions (based on severity), and/or flag unexpected underperformance and outperformance for further review.

Review of New Activities: Does your complex require prior approval from management for the use of new instruments, strategies, or asset classes? If so, does your process solicit suggestions from all affected areas of the complex before investments are made (e.g., trading, settlement, legal and compliance, accounting)? Many complexes formally or informally prohibit a portfolio manager from investing in new securities or using new investment techniques without the prior approval of management. Others impose limits on new securities/techniques until they have been appropriately vetted more completely within the complex. For some complexes, the vetting process will include "stress testing" of the security/technique under various hypothetical market conditions. Complexes frequently do additional review where different policies will be used for similar asset classes or strategies.

Portfolio Manager/Compliance Interaction: Does your complex encourage portfolio managers to seek guidance from compliance personnel before taking action? Is the compliance function respected within your complex? At most complexes interviewed, compliance has daily contact with portfolio managers, either orally or through e-mail, and most complexes actively encourage a policy that encourages portfolio managers to contact compliance personnel "when in doubt." Most complexes believe this approach works as long as compliance personnel are responsive (one complex requires that at least one member of compliance be available to answer questions at all times) and portfolio managers know who to go to for answers to questions. In addition, most complexes actively encourage compliance personnel to develop a good working relationship with portfolio managers. While some complexes believe it is helpful for compliance personnel to be in physical proximity to portfolio managers, few seem to believe that this is a critical requirement.

Training/Education: Do you train portfolio managers on compliance risks? Is your program appropriately tailored to their needs (i.e., portfolio manager-friendly)? Do you provide compliance training each time you establish a new portfolio or change a portfolio manager? Most of the complexes interviewed for the Study view informal training for portfolio managers as generally more effective than formal training — one complex characterized its approach as "opportunistic" training. For example, many complexes provide portfolio managers with training on new compliance developments as they occur, often in an informal setting or at a meeting where other (non-compliance) matters may be discussed. Other complexes hold regularly scheduled meetings with portfolio managers devoted exclusively to compliance matters. Many complexes have found that formal, "in depth" memos may be less effective than training targeted to the particular needs of the individual[s] in question. Most complexes also have a written compliance manual that is updated on a regular basis. Some complexes 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.

Compensation Policies: Are your compensation policies for portfolio managers and others consistent with your investment strategies? Many complexes seek to ensure that their compensation policies are consistent with the complex's investment strategies and do not provide incentives to portfolio managers and others to engage in conduct that is not consistent with those strategies. Some complexes also seek to ensure that compliance personnel understand compensation policies (consistent with legitimate personal privacy concerns) in order to monitor and identify conduct that may be compensation-driven.

ADDITIONAL RISK MANAGEMENT TECHNIQUES FOR PRIVATE ADVISORY ACCOUNTS

Failures to adhere to private advisory account guidelines and restrictions have been a significant source of exposure for ICI Mutual insureds, notwithstanding the view of some complexes that security selection for private advisory accounts involves less compliance risk than for fund accounts. It is true that private accounts often do not require daily pricing and that private advisory clients (particularly large institutional clients) are frequently knowledgeable as to the specific holdings of their accounts. However, managing risks in the private advisory area can be particularly challenging, given the sheer number of individual accounts and the variety of individual restrictions that may be involved at any given complex.

In developing risk management techniques for private advisory accounts, complexes may wish to consider the following questions, among others:

Review of Terms of Private Advisory Contracts: Does your complex require investment guidelines and restrictions in proposed advisory contracts to be approved prior to the contracts' execution? Ambiguities or omissions in written investment guidelines and restrictions subject complexes to potential exposure. Some complexes seek to use "standard" guidelines for private advisory accounts wherever possible, both to reduce the risk of ambiguities and omissions and to reduce the number of different guidelines and restrictions that must be complied with. During the contract approval process, complexes may solicit input and review from portfolio managers, in-house counsel, client-relation personnel, compliance personnel, and others to ensure that the guidelines and restrictions are complete, reflect the client's intentions, and are understood. Input and review are particularly important for "non-standard" guidelines. In such cases, complexes may wish to consider, on a case-by-case basis, whether the compliance risks outweigh the expected benefits of the potential relationship.

Documentation of Contract Amendments: Does your complex require all changes to investment guidelines and restrictions to be incorporated into an amended written advisory contract or otherwise documented in writing? Is there an internal review or approval process before changes can become effective? Failure to appropriately document changes to existing guidelines and restrictions creates potential exposure, particularly changes made through oral discussions or custom and practice. Clients have brought actions against complexes who failed to adhere to written guidelines, notwithstanding that the complexes' actions were consistent with longtime past practices for those same clients.

Incorporation of Documents by Reference: Does your complex permit external documents (such as statutes or "global" pension plan guidelines) to be incorporated by reference in, or attached as supplements to, private advisory contracts? These documents create potential conflicts between the terms of the advisory contract and those of the external documents. Accordingly, complexes may wish to limit incorporation or attachment of such documents to the extent possible, and carefully monitor them.

Compliance Testing or Screening: What types of formal procedures does your complex use to screen individual private advisory account trades for compliance with investment guidelines and restrictions? Many complexes use automated systems and software to screen trades before or after execution. While fully automated "front-end" compliance systems often have operational challenges and substantive limitations, some complexes believe they are a worthwhile adjunct to their risk management efforts. Other procedures used include manual checklists or approved lists of securities and periodic compliance audits conducted by internal or external sources. Firms that manage private accounts with a variety of different client-imposed compliance restrictions generally consider compliance testing and/or screening to be particularly important.

Portfolio Manager Review: Does your complex require portfolio managers to review clients' investment guidelines and restrictions on a regular basis? For many complexes, the portfolio manager (or other appropriate person) will regularly review investment guidelines and restrictions with the client to help ensure that they continue to be appropriate to the client's needs. Perhaps more importantly, regular review of guidelines and restrictions by the portfolio manager can create an important second line of defense against violations that might otherwise escape detection by compliance testing or screening.

Execution of Orders

POTENTIAL AREAS OF RISK

Once a portfolio manager has decided which securities to buy or sell, the purchase or sale order must be executed. Execution typically involves two steps: (1) the portfolio manager transmits the order internally to the trading desk, and (2) the trader arranges for execution of the order with a broker-dealer.

Good faith miscommunications and other errors can occur at a number of points during the order execution process. The most significant sources of risk in this area have involved (1) inaccurate execution of trade orders, and (2) unauthorized trading.

Inaccurate Execution of Trade Orders: Trades may be inaccurately executed as a result of system errors or errors by traders or other portfolio management personnel. 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.

- *Example — Incorrect Amount Entered.* In entering a buy order into the complex's trading system, a portfolio manager inadvertently added an extra zero to the number of shares to be purchased, resulting in a buy order ten times larger than intended. The erroneous purchase increased the fund's holdings in the stock to more than 6% of the fund's assets, rather than to the approximately 1% position intended, and resulted in an overdraft. The complex's trading system software did not have the capacity to alert users to unusually large trades entered into the system as a percentage of an account's total assets. While the trading system software was capable of alerting portfolio managers if a proposed purchase would cause an account to have more than 5% of its assets in one issuer, this function was not activated. Moreover, although portfolio managers received a daily trade summary report showing the number of shares purchased and sold for an account during the course of the day, the reports did not show trades as a percentage of a portfolio's assets. The error was not discovered until portfolio administration notified the portfolio manager of the fund's overdraft position. ***Loss to Complex: More than $600,000.***

- *Example — Incorrect Order Entered.* A complex placed a telephone trade with a broker-dealer to close out an existing currency hedging position. Although the broker-dealer's internal trade ticket correctly identified the trade as a *purchase* of yen, personnel at the broker-dealer incorrectly entered the order into the broker-dealer's system as a *sale* of yen. Later the same day, a portfolio administrator for the fund complex erroneously confirmed the transaction orally to the broker-dealer as a *sale* of yen. Subsequently, the broker-dealer sent several written confirmations of the trade to the fund complex in which the trade was identified as a *sale* of yen, but these paper confirmations were not reviewed by the complex's administrative personnel. The broker-dealer also sent month-end statements to the complex's portfolio administration department in which the trade was identified as a *sale* of yen, but the fund complex had no procedures in place to reconcile the statements with the complex's fund accounting system. The error was not discovered and corrected until two months later, at settlement. The parties ultimately agreed to share responsibility for the amount required to correct the error. ***Loss to Complex: More than $500,000.***

- *Example — Transposed Instructions.* A portfolio manager placed an order to sell "all" shares of a particular technology security held by a managed fund. As called for by the complex's procedures, the head trader prepared a ticket for the order using a spreadsheet report of fund holdings. The head trader, aware of a systems problem that had prevented the spreadsheet report from being updated to reflect the prior day's trading activity, made a handwritten notation of the updated share amount next to the name of the portfolio company on the report. In doing so, the head trader inadvertently transposed the shares of the security with another line item. As a result, the trader wrote a trade ticket for more than double the amount of shares of the security actually held by the fund. The sale caused the fund to violate a fundamental policy prohibiting uncovered short positions. The complex had no procedures requiring portfolio managers to identify the specific number of shares to be sold, or for other precautionary steps to be taken prior to trade entry, other than reliance on traders to double check orders. ***Loss to Complex: More than $150,000.***

Unauthorized Trading: Losses can result when trades are not authorized by appropriate portfolio management personnel. In some cases, such unauthorized trading may be traced to a good faith misunderstanding or miscommunications between portfolio management personnel and the trading desk. Less frequently, a trader may deliberately or recklessly make unauthorized trades.

- *Example — Trade in Excess of Guidelines.* A complex's procedures prohibited a trader from executing certain trades unless he first received a written trade ticket from the portfolio manager. However, the trader did not obtain a trade ticket for the purchase in question, which exceeded established guidelines. ***Loss to Complex: $100,000.***

- *Example—Concealed Trading.* Portfolio managers and supervisory personnel were charged with failing to monitor or detect grossly excessive trading in futures by an employee to whom limited trading discretion had been granted, resulting in regulatory investigations. In many cases, the employee sought to conceal his activity by forging, miscoding, or not submitting trade tickets. ***Loss to Complex: More than $20 million.***

RISK MANAGEMENT TECHNIQUES

In addressing these risks, complexes may wish to consider the following questions, among others:

Authority of Portfolio Managers/Traders: Does your complex have policies and procedures designed to limit errors in trading activities by portfolio managers and traders? Do you allow portfolio managers to trade for client accounts or is all trading done by traders? How are trades assigned to traders? How much discretion is given to traders in executing trades? Some complexes seek to limit the risk of trading errors by completely separating the portfolio management and trading functions or by allowing portfolio managers to give only limited instructions to traders. Other complexes may allow portfolio managers to do limited trading (e.g., trading in fixed income securities or international securities). To limit the opportunity for errors or abuses, some complexes assign particular trades to traders on a random basis, except for specialized areas (e.g., foreign exchange, derivatives). Most complexes give traders some degree of time and price discretion, but not investment discretion.

Trade-Related Communications Between Portfolio Managers and Traders: Does your complex have procedures to promote accuracy of trade-related communications between portfolio managers and traders? If so, are electronic or manual systems in place to help prevent errors? Do you use backup checks to prevent/eliminate errors? Complexes take a variety of steps to reduce or eliminate mechanical errors in trading. Although some complexes link portfolio managers and traders electronically, many rely on oral communications. For complexes that use oral communications, many insist on confirmation of all trade orders. Many complexes believe that some level of mechanical errors is inherent in the trading process (with some believing that this risk is greater with electronic trading systems). To address such errors, many complexes use backup checks to prevent or limit errors, such as requiring written confirmation of oral orders, applicable compliance limits to be noted on trade tickets, or portfolio managers to receive notification when approaching a compliance limit.

Appropriate Oversight: Does your complex have appropriate controls on the trading function? Do traders understand the nature and extent of their authority (e.g., time and price discretion)? Many complexes use a central trading desk, and larger complexes frequently have an official or unofficial "head trader" at the central trading desk. Under this approach, typically the head trader routes trades to traders based on experience or expertise, although at some complexes portfolio managers have designated traders. Many complexes have developed written policies and procedures that establish the parameters of traders' authority and discretion in exercising trades.

Separation of Functions: To reduce the potential for good faith errors and intentional misconduct, does your complex separate front, middle, and back office trading functions wherever possible? If separation is not possible because of limited staff, have you established alternative checks, balances, and controls, such as an independent third party audit? Many complexes separate the clearing and settlement function from trading. Where separation is not feasible, many complexes rely on some type of internal oversight and/or independent audit of trading.

Training/Education: How does your complex train traders on investment management compliance risks? Is your training appropriately tailored to their needs (i.e., is it trader-friendly)? In addition to general training on compliance matters, some complexes have a portion of their formal training dedicated to the compliance aspects of the trading function that is tailored to the needs of traders. Some complexes use electronic means to deliver compliance training to traders (e.g., by posting compliance memos on a website for traders and other employees). At most complexes, traders seem to have less day-to-day interaction with compliance personnel than do portfolio managers.

Brokerage Allocation

POTENTIAL AREAS OF RISK

In allocating brokerage, the primary goal for complexes is to obtain best execution. In determining whether any particular broker-dealer will provide best execution, a complex may consider a variety of factors, including the quality of brokerage services, the receipt of brokerage and research services, and the sale of fund shares/client referrals by the broker-dealer (subject to compliance with applicable disclosure and other requirements).

The most important sources of risk in this area occur when brokerage is allocated under circumstances suggesting that the complex or an employee, rather than obtaining best execution for clients, is seeking its own advantage.[6] The most significant sources of risk in this area have involved (1) traders placing trades based on a personal relationship with a broker, (2) traders placing trades as part of a "kickback" scheme, and (3) complexes using brokerage inappropriately to reward fund sales/client referrals.

- *Example — Placing Trades Based on a Personal Relationship.* A portfolio manager executed trades through a brokerage firm with which the manager had a long-standing relationship (and by which he was later employed), at allegedly excessive costs to the funds involved. ***Loss to Complex: More than $3 million.***

- *Example — Kickback Scheme.* Brokerage firms allegedly illegally kicked back millions of dollars in commissions to a pension fund manager. Criminal and civil regulatory proceedings are ongoing.

- *Example — Undisclosed Use of Client Brokerage to Reward Client Referrals.* A complex failed to disclose that it used client commissions, mark-ups, and mark-downs to compensate broker-dealers for client referrals, and in some cases, traders concealed that they did not seek best execution on certain trades directed to one of the referring broker-dealers. The complex did not disclose these practices to clients and, in fact, represented to clients that brokers were selected on the basis of research provided. ***Loss to Complex: More than $1.9 million.***

RISK MANAGEMENT TECHNIQUES

In addressing these risks, complexes may wish to consider the following questions, among others:

Allocation Procedures: How does your complex seek to ensure that brokerage is allocated consistent with best execution? Do you review this process regularly? Does your process include input from portfolio managers, traders, and other interested persons? Many complexes have a formal process for allocating brokerage that frequently is set forth in written procedures. Typically, portfolio managers and traders are active participants in this process or are otherwise encouraged to give input. Many complexes review their allocation process at least annually, though many have a more frequent review schedule (semiannually or quarterly).

Approved List: Does your complex have an approved list of broker-dealers or other formal process for determining which broker-dealers you will use? Many complexes have a formal or informal "approved" list identifying those broker-dealers with which traders may place trades. Typically, complexes complete a formal or informal due diligence process before adding a new broker-dealer to the list. In many complexes, traders cannot use a broker-dealer that is not on the list (although in some cases a trader, with approval, may be allowed to go "off the list" for a complex or difficult trade that may require specialized expertise).

Selection of Broker-Dealers Motivated by Personal Relationships: How does your complex seek to ensure that your traders or other employees do not place trades with broker-dealers because of personal relationships? Many complexes interviewed have formal or informal policies that apply to the selection of broker-dealers where a trader has a personal relationship with someone at the broker-dealer (e.g., the trader's spouse or a relative is employed at the broker-dealer). Some complexes require prior approval of these arrangements, while others do not allow the trader to participate in the selection process or prohibit these arrangements.

Business Entertainment/Gift Policy: Does your complex have a formal policy describing what business entertainment and gifts or gratuities traders and others may accept from broker-dealers and other parties with which the complex does business? Are these policies consistently enforced? Regarding business entertainment, many complexes seem to use informal policies for determining what is acceptable business entertainment by vendors and others with whom the complex does business. In some cases, the head trader or other appropriate person must pre-approve any business entertainment not in the ordinary course of business. Except where required by regulation,[7] many complexes also seem to use informal policies regarding the receipt of gifts. Some complexes prohibit traders and others from receiving gifts of other than nominal value, while others require compliance department approval for all gifts or place a dollar limit on gifts.

Allocation of Securities to Client Accounts

POTENTIAL AREAS OF RISK

Complexes frequently have an opportunity to purchase a security that may be appropriate for more than one client account. When a limited amount of a security is available at a given time, it must be allocated to client accounts in a fair and equitable manner.

The most significant sources of risk in this area have involved securities being allocated in a manner that favors certain clients or groups of clients.[8] The risk is particularly significant if the complex has an economic interest in the favored accounts (e.g., an in-house pension plan, accounts that pay a performance fee) or a business interest in increasing the favored account's investment returns (e.g., the client is a source of referrals).

Favoring In-House Accounts — Securities may be allocated in a manner that favors accounts for employees of the complex.

- *Example — Favoring In-House Pension Plan in Allocations.* A portfolio manager responsible for managing registered funds and the complex's private profit-sharing plan diverted certain investment opportunities rightfully belonging to the funds to the profit-sharing plan. ***Loss to Complex: More than $10 million.***

- *Example — Equity "Kickers."* A portfolio manager for registered funds and for the complex's employee benefit plan purchased debt securities with equity "kickers." Although the employee benefit plan did not purchase any of the high yield debt securities, the portfolio manager nevertheless allocated some of the common stock from the equity "kickers" to the plan and not to the registered funds, without disclosure to the funds. The plan purchased the equity at a nominal price unrelated to the equity's potential value, and subsequently realized a five-fold return on its original investment. The SEC brought an action against the complex and the portfolio manager and brought a "failure to supervise" charge against the portfolio manager's supervisor. ***Loss to Complex: Defense costs; Damage to reputation.***

Favoring Certain Client Accounts: Securities that should be allocated to one or more clients instead may be unfairly allocated to another client.

- *Example — Favoritism in IPO Allocations.* A portfolio manager favored an aggressive growth fund over other funds under his management in allocating IPO investments, a practice that was not disclosed. In addition to failure to disclose and antifraud liability, the complex was charged with failure to supervise the portfolio manager. Class action lawsuits followed. ***Loss to Complex: More than $22 million.***

RISK MANAGEMENT TECHNIQUES

In addressing these risks, complexes may wish to consider the following questions, among others:

Trade Allocation: Has your complex adopted written trade allocation procedures? Are they applied consistently across all client accounts and asset classes? How does your complex seek to ensure compliance with the procedures? Almost all complexes interviewed had written allocation procedures. Typical trade allocation procedures at complexes interviewed for the Study include allocating trades proportionately; randomly; rotationally; based on account objective or size; and, in some cases, based in whole or in part on brokerage commissions generated. Most complexes apply their procedures consistently across all similarly-situated client accounts and require additional approvals and review of any variations. Many firms regularly audit their procedures to ensure that securities are being allocated properly.

Dual Management of Hedge Funds/Registered Funds: Does your complex monitor and/or limit the extent to which a portfolio manager may manage both accounts that generate a performance fee and accounts that do not? Many complexes expressed concern about the potential trade allocation issues that may be presented when a portfolio manager manages both a registered mutual fund and a hedge fund, the latter of which may allow the portfolio manager to participate in the adviser's performance fees. Some complexes completely separate these activities, while others impose procedures and monitoring to address any conflicts of interest.

IPO Allocations: Does your complex have procedures specifically addressed to the allocation of IPO opportunities? Many complexes have written procedures for the allocation of IPOs and other limited availability investments, consistent with SEC staff guidance in this area.[9] Some complexes interviewed do not permit accounts that pay performance fees to participate in an IPO opportunity.

Disclosure: Does your complex make appropriate disclosure concerning its trade allocation procedures? Many complexes interviewed include such disclosure (in varying levels of specificity) in fund prospectuses, SAIs, and Form ADV.

Pricing of Portfolio Securities

POTENTIAL AREAS OF RISK

Once securities have been allocated to client accounts, they must be valued or "priced" properly (typically daily for mutual funds), and the prices must be accurately recorded in the complex's books and records for purposes of calculating net asset values/account values. Recently, the SEC Staff has focused particular attention on the need for sound valuation procedures for mutual funds.[10]

Net asset values or account values may be misstated because portfolio securities are incorrectly priced as a result of administrative oversights or errors, coupled with failures of back-up procedures. Portfolio securities also may be incorrectly priced because of reckless or intentional misconduct by portfolio management personnel. The Study suggests that the most significant sources of risk in this area have involved (1) administrative errors in recording the details of trades (e.g., amounts, CUSIP numbers, etc.), and (2) intentional misconduct by portfolio management personnel, who may be motivated to engage in such misconduct to obtain favorable performance for the account, to preserve their employment, or for other reasons.

Inaccurate Recording of Trades: If executed trades are not recorded correctly, net asset values/account values will not be accurate and the portfolio manager will not have accurate information about positions held in client accounts, which may lead to further errors.

- *Example—Unrecorded Trades.* Due to an administrative oversight, a number of purchases and sales made for a multi-manager fund were not contemporaneously recorded in the fund's accounting records, resulting in the fund's net asset value being overstated for six months. The administrator's comprehensive procedures manual did not cover the situation where the fund was advised by outside advisers. Moreover, the administrator failed to perform (or improperly performed) daily reconciliations designed to identify discrepancies between the fund's records and the custodian bank's records, and the administrator did not investigate large "reconciling items" on certain monthly reports. The recording error was compounded by various data entry errors. ***Loss to Complex: More than $1 million.***

Intentional Misconduct: In some cases, portfolio managers or others may intentionally provide incorrect securities prices to complexes to attempt to cover up poor performance or for other inappropriate reasons.

- *Example — False Prices.* Over several months, in the course of liquidating a fund's position in certain securities, a portfolio manager used inflated prices for a number of securities. Specifically, after two registered broker-dealers stopped providing daily prices on certain securities, the portfolio manager began to price them himself, but falsely noted on the fund's daily pricing sheets that the prices had been obtained from the two broker-dealers. The portfolio manager also provided a broker-dealer with pricing assumptions for use in calculating the prices of certain of the other securities, and requested in certain cases that he be supplied with offered, rather than bid side, prices each day. As a result, the fund's net asset fund was inflated during various periods of time. ***Loss to Complex: $3 million.***

RISK MANAGEMENT TECHNIQUES

In addressing these risks, complexes may wish to consider the following questions, among others:

Valuation Procedures: Does your complex have written valuation procedures? Are your pricing methodologies known, understood, and consistently followed? Do you document the basis for all valuations? Most complexes interviewed have written valuation procedures that are communicated to all personnel involved in the valuation process, and significant compliance resources are dedicated to ensuring that valuation procedures are understood and implemented. Many complexes also have established pricing or valuation committees to aid in administering the valuation process.[11]

Pricing Challenges: Do you have procedures specifying how and to what extent portfolio managers may make pricing challenges? If portfolio managers are involved in the challenge process, what checks, balances, and controls are in place? Most complexes have adopted formal or informal policies that enable portfolio managers and others to "challenge" securities valuations from independent pricing services and other sources that they believe are not reliable, particularly for illiquid or thinly-traded securities (e.g., high-yield securities, foreign securities, restricted securities). The policies typically define the circumstances under which a challenge takes place, and frequently require a minimum "materiality" threshold before allowing a challenge to proceed. In light of the potential conflicts when portfolio managers are involved in valuation decisions, the policies typically include mechanisms that preclude portfolio managers from unilaterally changing a valuation, though these policies recognize that portfolio managers need to have input into the process. All complexes interviewed require evidence to support a portfolio manager's suggested price. Some complexes allow portfolio managers to obtain quotes from brokers and then have others verify them, while other complexes require someone other than the portfolio manager (e.g., fund accountants) to obtain quotes.

Pricing Services: If you use an independent pricing service, have you established appropriate monitoring procedures? When you use a pricing service, do you periodically check its valuations with other sources (e.g., a second pricing service)? Most complexes interviewed use one or more independent pricing services to value at least some of their securities. In such cases, complexes also follow a variety of formal and informal practices to monitor the reasonableness of the pricing service's valuations, such as reviewing prices with brokers and other market participants and periodically using a second independent pricing service to verify the reasonableness of valuations.

Risk Tolerance Tools: Do you use risk tolerance tools to verify valuations (e.g., enhanced procedures where a security does not trade for a specified number of days or its value moves more than a specified percentage in a day)? Many complexes use supplemental risk tolerance tools to verify valuations, the specific nature of which depends on factors such as the nature of its investment products and the complex's size. For example, some complexes will check valuations manually if a security does not trade for a specified number of days or if its price does not change for a number of days. Others will check valuations manually if a security's valuation moves more than a predetermined amount in a day. Still others check valuations where a change in a security's valuation moves a mutual fund's net asset value by a prescribed amount, such as one cent per share.

Disclosure

POTENTIAL AREAS OF RISK

Various provisions of the securities laws regulate disclosure about investment management in prospectuses, Form ADVs, advisory contracts, shareholder reports, and marketing materials used by complexes.

Complexes and/or individual personnel are exposed to potential liability when they fail to make full and fair disclosure as required by law and regulation. Errors may include:

- Inaccurate/incomplete disclosure of matters specifically required (e.g., in fund prospectuses, Form ADV).

- Failure to disclose other material facts to clients/fund directors.

Over the years, shareholders have filed a number of actions against mutual funds and their investment advisers alleging, among other things, inadequate risk disclosure.[12] (Allegations of inadequate disclosure also frequently accompany allegations of errors in several of the investment management areas described above). Even when successfully defended or settled, these types of actions can involve very significant losses to fund complexes. Indeed, more than one-third of all amounts paid by ICI Mutual on insurance claims have involved allegations of false or misleading disclosure.

RISK MANAGEMENT TECHNIQUES

In seeking to manage these risks, complexes may wish to consider the following questions, among others:

Review of Regulatory Disclosure Documents: Does your complex have a formal procedure for periodic review of regulatory documents (e.g., prospectuses and Form ADVs)? Are portfolio managers a part of this process? Does this review focus on ensuring that your disclosure is consistent with your current investment strategies? As a supplement to traditional legal review, most complexes formally involve portfolio managers in the review of regulatory disclosure documents, such as fund prospectuses and Form ADVs, or provide portfolio managers with the opportunity to comment upon disclosure documents for the product[s] they manage. Typically this review occurs annually, and in many cases complexes highlight changes from the prior version to focus the portfolio manager's attention on significant matters. For some complexes, the process also includes a face-to-face meeting with the portfolio manager by compliance personnel (or the opportunity for such a meeting if the portfolio manager wishes), while other complexes hold meetings only where a portfolio manager wishes to make a significant change to a disclosure document.

Review of Marketing Materials: Are your portfolio managers included in the review of marketing materials? If not, does your complex otherwise have a process to ensure that your products and services are marketed in a manner consistent with your investment strategies and regulatory disclosure documents? As a supplement to traditional legal review, many complexes involve portfolio managers in the review of marketing materials for the product[s] they manage (or provide managers with the opportunity to comment if they wish), particularly for materials that discuss or focus on portfolio management issues. In some cases this review is made by client relationship staff who are familiar with portfolio management issues. Sometimes portfolio managers are asked to approve new marketing materials, or new combinations of existing materials.

Management Oversight Of Investment Management Compliance

The SEC and other regulators expect management to exercise appropriate oversight over the investment management process, irrespective of the nature of a complex's business, its history, or its culture. Clearly, an appropriate "tone at the top" is an integral part of any complex's compliance program,[13] and the federal securities laws impose significant liability on the management of regulated entities, including individuals, for failure to exercise appropriate supervision over the complex's activities.[14] If the SEC becomes aware of a significant investment management error, the complex should expect that the SEC will, among other things, examine the adequacy of the complex's supervisory structure. This examination will be conducted with the benefit of 20/20 hindsight and is likely to focus on whether appropriate management oversight could have prevented, or reduced the likelihood of, the error. If the SEC concludes that the complex's supervisory efforts were deficient, the SEC-mandated remedy is likely to provide less flexibility than if the complex had addressed the matter on its own initiative.

Legal and regulatory concerns aside, common-sense business practice also indicates that a complex should ensure that a specific individual or group of individuals within the complex exercises an appropriate degree of oversight over investment management compliance risks. While the person[s] who provides this oversight may often have many other duties, as many insured complexes describe it, "someone" at the complex needs to be aware of and understand the compliance risks raised by investment management activities, both at the individual portfolio manager level and at the complex-wide level.

What Should Oversight Encompass?

Management's oversight needs to be structured in a manner that appropriately addresses investment management compliance risks in light of the needs of the complex, its history, and its culture. Clearly, the appropriate level of oversight must be reasonably designed to protect the complex without unnecessarily stifling legitimate entrepreneurial activities. Therefore, as ICI Mutual's interviews with complexes show, the nature of the oversight function will necessarily vary from complex to complex, and likely will vary significantly.

Nevertheless, the Study shows that all complexes should consider including an appropriate mix of micro and macro elements in structuring their oversight function. A micro focus is necessary to ensure that the risks raised by the specific actions of an individual portfolio manager (and others) are understood and, to the extent possible, reduced. A macro focus, on the other hand, looks to the overall risks to the complex that are raised by the individual actions of a variety of individual portfolio managers (and others). A macro approach seeks to understand those risks that arise from the complex's activities as a whole and, to the extent possible, reduce them.

In designing an effective oversight function, complexes may wish to consider the following questions, among others:

- *Stature* — Does the person[s] responsible for the oversight function have the necessary authority and stature within the complex to exercise effective oversight of investment management compliance? Has this authority been clearly articulated to, and accepted by, all personnel within your complex? Are appropriate resources devoted to the oversight function? When an unacceptable compliance risk is identified, is the person[s] providing oversight in a position to take action immediately, or to ensure that prompt action is taken by others, including any necessary disciplinary action?

- *Two-Way Communications* — Does the person[s] providing oversight communicate effectively within the complex on compliance risk matters? In addition to informal communications, does the person[s] use appropriate formal communications to ensure that all within the complex understand their role in seeking to reduce compliance risks? What steps does your complex take to encourage a firm culture in which personnel feel comfortable communicating their compliance risk concerns to management (e.g., are they confidential to the extent possible, do personnel see management take action where appropriate)?

- *Regular Evaluation and Assessment* — How do you seek to ensure that appropriate policies and procedures are in place? How do you seek to ensure that the adequacy and effectiveness of these policies and procedures are regularly reevaluated? Does your reevaluation process seek to incorporate the views of all affected personnel within the complex?

- *Education/Training* — Do you have formal or informal training programs designed to ensure that personnel are aware of and sensitive to the risks posed by or relating to their activities? Is management involved in planning and/or reviewing the adequacy of the educational and training programs? Does your firm clearly convey to each person involved in investment management compliance the nature of their duties and responsibilities?

How May Complexes Structure Oversight?

As noted above, there is no single "best" approach for oversight of investment management compliance. While this Study suggests that complexes face the same general types of compliance risks, it is also clear that complexes need to structure their oversight of investment management compliance in a manner that accommodates the complex's size, organization, and existing hierarchy.

A typical approach for many complexes is to appoint an individual to spearhead the complex's oversight efforts. Other complexes appoint multiple individuals and collectively give them oversight responsibilities. Still other complexes use committees and formal procedures to oversee matters such as vetting new products, reviewing the performance of current products, and vetting new investment techniques for existing products. Many complexes use a combination of these different approaches.

Among the different approaches to oversight of investment management compliance used by complexes are the following:

- *Day-to-Day Role in Portfolio Management* — In some complexes, those exercising oversight are intimately involved in actual portfolio management, including compliance risks, through weekly reviews with managers, vetting of all new investment techniques, etc. Within this category, some manage by asking questions or making suggestions and others play a more active role in managing the activities of portfolio managers.

- *Full Time/Part Time* — Complexes vary as to the time commitment expected of those exercising oversight over investment management activities. In some complexes, the position is full-time; in others, the individual(s) may have other responsibilities in addition to oversight, such as managing funds and/or other accounts or other management responsibilities within the complex.

- *Investment Management Experience* — Many complexes believe that those responsible for oversight should have hands-on experience in money management. Other complexes believe that talented individuals with different backgrounds and experience provide a useful perspective for the oversight function.

- *"Oversight by Committee"* — Some complexes use one or more committees to oversee investment management compliance, in lieu of assigning this task to a specific individual or as a supplement to the oversight activities of an individual. For example, one complex provides oversight through portfolio management review group meetings, at which portfolio managers make regular presentations to complex personnel regarding the management of client accounts.

Endnotes

[1] Note: although it is beyond the scope of this Study, the SEC also has sanctioned a number of portfolio managers for inappropriate personal securities trading.

[2] Note: Where this Study uses the phrase, "Loss to Complex," the associated dollar figure does not represent monetary loss to fund shareholders or clients, but to the fund complex. The figure is not adjusted for any insurance proceeds or other recovery received by the fund complex.

[3] Of course, any complex faces potential franchise risk issues in many areas in addition to investment management compliance. This study thus discusses only one aspect of franchise risk.

[4] See, e.g., *Dawson-Samberg Capital Mgmt., Inc. and Judith A. Mack*, Investment Advisers Act Rel. No. 1889 (Aug. 3, 2000); *MPI Investment Management, David Pequet and Ashok Shende*, Investment Advisers Act Rel. No. 1876 (June 12, 2000); *Schield Management Co*., Investment Advisers Act Rel. No. 1871 (May 31, 2000).

[5] See, e.g., *Olkey v. Hyperion 1999 Term Trust, Inc*., 98 F.3d 2, 8 (2d Cir. 1996) ("Not every bad investment is the product of a misrepresentation."), cert. denied, 520 U.S. 1264 (1997).

[6] See, e.g., *Duff and Phelps Investment Management Co., Inc.* Investment Advisers Act Rel. No. 1984 (Sept. 28, 2001); *Founders Asset Mgmt. LLC and Bjorn K. Borgen*, Investment Advisers Act Rel. No. 1879 (June 15, 2000); *Securities and Exchange Commission v. Alan Brian Bond and Robert T. Spruill*, Litigation Rel. 16394 (Dec. 16, 1999); *In re Fleet Investment Advisors, Inc. (successor to Shawmut Investment Advisers, Inc.)*, Investment Advisers Act Rel. No. 1821 (Sept. 9, 1999*); In re Robert Burstein*, Investment Advisers Act Rel. No. 1511 (July 28, 1995).

[7] For example, NASD Rule 2830(l) provides limits on gifts and business entertainment that may be received by employees of a broker-dealer.

[8] See, e.g., *F.W. Thompson Company, Ltd. and Frederick W. Thompson*, Investment Advisers Act Rel. No. 1895 (Sept. 7, 2000); *The Dreyfus Corporation and Mark L. Schonberg*, Investment Advisers Act Rel. No. 1870 (May 10, 2000); *Van Kampen Investment Advisory Corporation and Alan Sachtleben*, Investment Advisers Act Rel. No. 1819 (Sept. 8, 1999).

[9] See, e.g., *SMC Capital, Inc*., SEC No-Action Letter (Sept. 5, 1995).

[10] See, e.g., Letters to Craig Tyle, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, SEC, dated April 30, 2001 and December 9, 1999.

[11] Guidance from the SEC and its staff on valuation focuses primarily on the need for a rigorous and flexible valuation process that incorporates all appropriate factors relevant to the value of a security. See Accounting Series Rel. No. 118 (Dec. 23, 1970); Accounting Series Rel. No. 113 (Oct. 21, 1969); and Letters to Craig Tyle, ICI, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, SEC, dated Dec. 8, 1999 and April 30, 2001.

[12] See, e.g., *White v. Heartland High-Yield, et. al,* Case No. 00-C-1388 (E.D. WI March 27, 2001); *In re TCW/DW North American Government Income Trust Securities Litigation*, 941 F. Supp. 326 (S.D.N.Y. May 8, 1996); *In re Alliance North American Government Income Trust, Inc. Securities Litigation*, 159 F.3d 723 (2d Cir. 1998); *Sheppard v. TCW/DW Term Trust 2000*, 938 F. Supp. 171 (S.D.N.Y. Aug. 16, 1996); *Schaefer v. Overland Express Family of Funds*, Civil No. 95-0314-B (POR), 169 F.R.D. 124 (S.D. Cal. July 3, 1996).

[13] See *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, Securities Exchange Act of 1934 Rel. No. 44969 (Oct. 23, 2001) (in deciding not to take action against a company it had investigated, the SEC noted that one measure of the company's cooperation with the SEC was its self-policing prior to the discovery of the misconduct, including an appropriate "tone at the top").

[14] See, e.g., Section 15(b)(4)(E) of the Securities Exchange Act of 1934, Section 203(e)(6) of the Investment Advisers Act of 1940.

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