ACA COMPLIANCE GROUP

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PERFORMANCE SERVICES

ACA'S SPRING 2015 **COMPLIANCE CONFERENCE**

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Trade ~~Erroes~~ Errors

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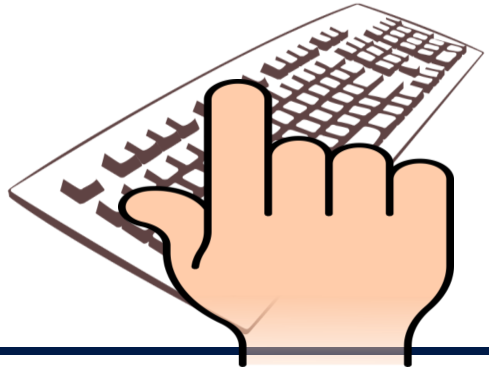
Agenda

- What is a Trade Error?
- Legal Obligations of Advisers with Respect to Trade Errors
- Preventing and Detecting Trade Errors
- Correcting Trade Errors
- Calculating Gains/Losses Resulting from a Trade Error
- Documenting Trade Errors
- Duty to Disclose Trade Errors
- Trade Error Procedures

What is a Trade Error?

- Scope of the term has never been clearly defined by SEC
- Types of trade errors:
  - Failure to properly execute an instruction of a portfolio manager:
    - Buy order entered instead of a sell order or vice versa
    - Wrong security purchased or sold
    - Security purchased or sold in incorrect amount or price
    - Trade executed for wrong account

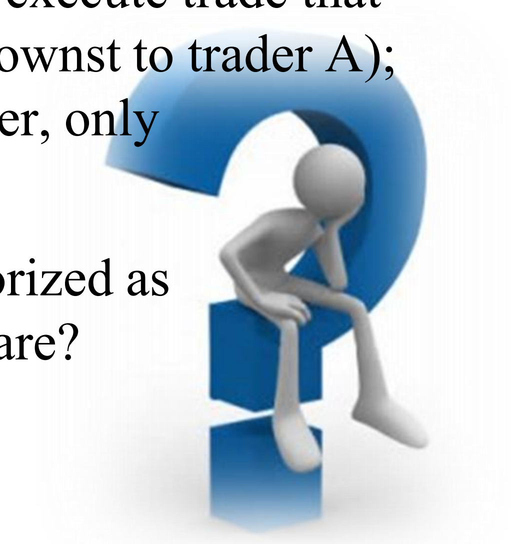


What is a Trade Error?

- Other less obvious trade errors:
  - Transaction effected in violation of investment guidelines
  - Reconciliation errors occurred
  - Limit order trade executed at market price
  - Client’s instruction not followed
  - Order to buy a position was placed but insufficient funds to cover purchase
  - Bunched trades allocated incorrectly

What is a Trade Error?

- Situations less easily categorized as a trade error:
    - Portfolio manager instructs trader to make the trade, but trader, who usually trades within minutes, is delayed and perhaps does not place trade until next day
    - Lack of communication that causes trader A to execute trade that has already been executed by trader B (unbeknownst to trader A); no mistake in actual entry and execution of order, only in communication between traders
- Regardless of whether a specific situation is categorized as a trade error, has the adviser breached its duty of care?



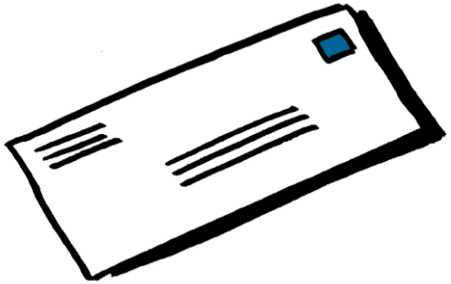
Legal Obligations of Advisers with Respect to Trade Errors

Fiduciary Duty

Under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subrogate clients' interests to its own. An adviser must deal fairly with clients, seek to avoid conflicts with its clients and, at a minimum, make full disclosure of any conflict or potential conflict.

Amendments to Form ADV, Advisers Act Rel. No. 3060 (July 28, 2010), citing *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180 (1963); *In the Matter of Arleen W. Hughes*, Exchange Act Rel. No. 4048 (Feb. 18, 1948).

Legal Obligations of Advisers with Respect to Trade Errors



Fiduciary Duty and Lerner

- Charles Lerner, No-Action Letter (Oct. 25, 1988):

  SEC's general view is that "an investment manager has an obligation to place orders correctly [and] if any investment manager makes an error while placing a trade [then it] must bear any costs of correcting such trade"

- SEC did not address effect on investment manager's responsibilities to its client of disclosure to client of investment manager's commission practices or of contractual provisions expressly designed to modify these provisions

Legal Obligations of Advisers with Respect to Trade Errors

Alternative Approaches / Disclosure and Consent

- Modification of fiduciary duty requires **informed consent**
- Clear disclosure is key – normally includes:
- What adviser considers to be a trade error
  - Who bears losses
  - Who gets gains
  - Any exceptions to basic policy
  - If clients bear losses, reason for policy
- Not generally necessary to describe specific procedures

Preventing and Detecting Trade Errors

Internal Controls

1. Understanding of the difference between legal and compliance perspective
2. Policies and procedures that provide supervision over order entry and execution
3. Adequate training and education – know general buy and sell side procedures
4. Separation of portfolio manager and trader

Preventing and Detecting Trade Errors

5. Verification of positions prior to order entry
6. Verification of total securities to be traded if using trade blocking system
7. Communicating precise trading requirements
8. Immediate review/affirm each trade execution
9. Communication to PM as soon as trades executed

Preventing and Detecting Trade Errors

10. Ensure holidays are considered for all markets traded
11. Trader or manager signoff on completed trades for execution and price verification
12. Supervisor signoff at day end
13. Monthly/quarterly review of all errors to determine risks, procedure needs, training
14. Ensure that trading processes are emotion free

Preventing and Detecting Trade Errors

Technology Controls

1. Adequate trading system to address current needs
2. Accurately code order tickets/transmission to ensure easy trade input, i.e., sell vs. sell short, stop vs. stop loss, covered option vs. uncovered option
3. Ensure allocation procedures and end-of-day procedures are fairly electronic
4. Ensure step out process is accurate and all parties will participate in execution

Preventing and Detect Trade Errors

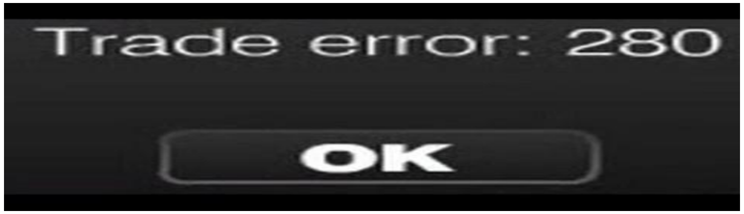
Technology Controls

5. Ensure proper registration in non-domestic exchange markets
6. Know entity and conduct due diligence on dark pool trading and ETN activities
7. Adequate training and education
8. Adequate BCP plan for communicating and affirming trades
9. Ensure that traders are still "thinking" and not totally relying on electronic systems

Correcting Trade Errors

- Cancellation
- Reallocation
  - reallocated securities represent a legitimate investment decision on behalf of account receiving the securities
  - reallocation is done without a loss to the account receiving the securities
- Trades may only be canceled or reallocated prior to settlement and only if it can be documented that broker/dealer did not suffer any loss
- Buy/sell the offending security
- Buy/sell a different security

Correcting Trade Errors



Approaches

- Client realizes gains / adviser bears losses
  - Gains realized by a client's account as a result of an error remain in the account
  - Losses realized by an account as a result of an error are reimbursed
  - Losses subject to interest if not paid timely
- Error accounts – client does not get gain or loss

Correcting Trade Errors

Approaches

- Netting gains and losses
  - Cannot net gains and losses in different funds
  - Cannot net with ERISA investors
  - Net only for trade errors occurring within a short and finite time span
- Netting differences and including decline in applicable index or market value for the period
- Client bears losses unless adviser has violated its standard of care
  - Often adviser must refrain from conduct that amounts to gross negligence, willful misconduct or violation of applicable law

Calculating Gains/Losses Resulting from a Trade Error

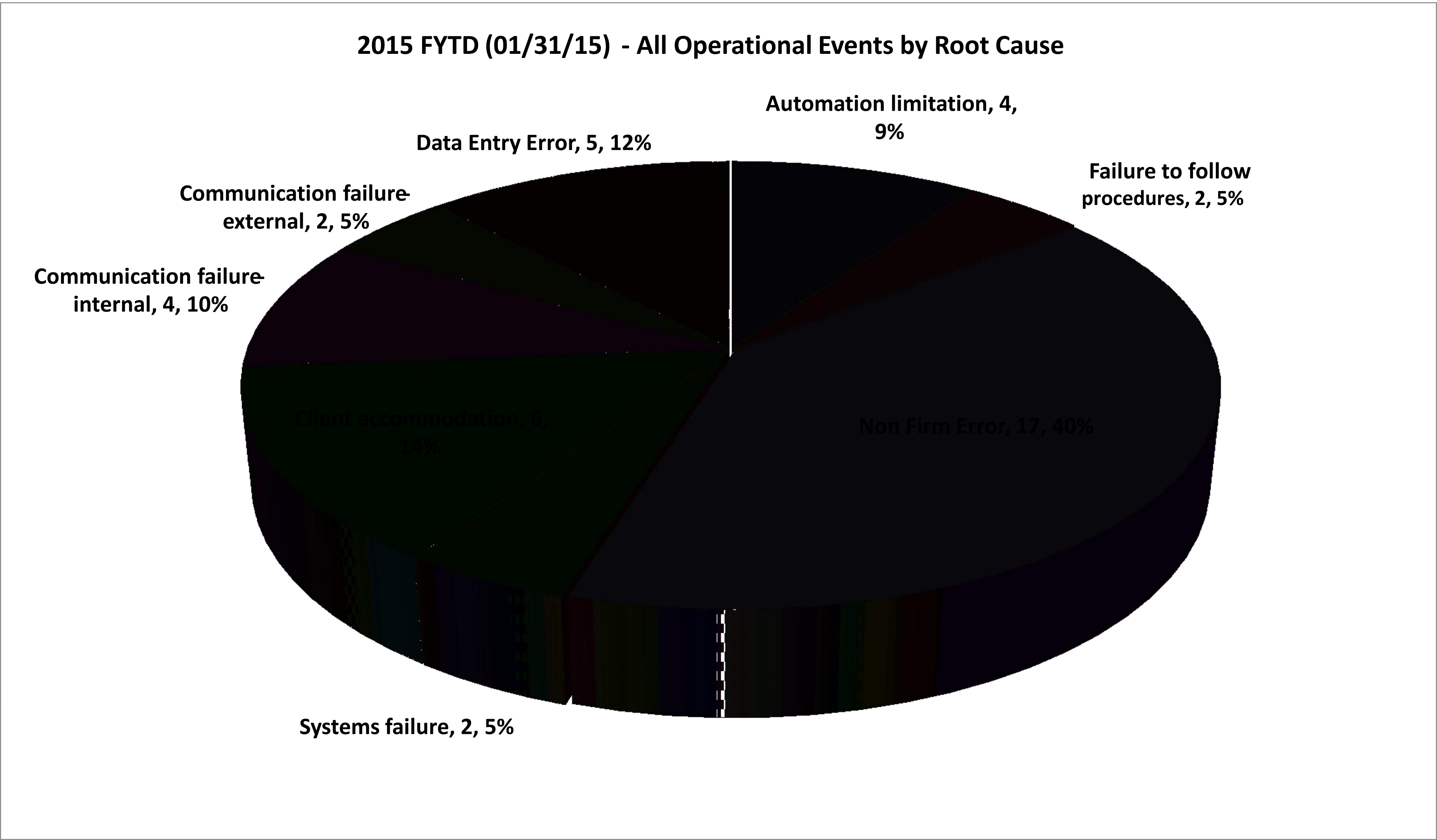
1. Straight order difference including fees and possible charges (pending splits, dividends, etc.)
2. Portfolio analysis of total gains/losses (rate of return)
3. Portfolio opportunity costs
4. Risk assessment difference
5. Market exposure assessment difference

Documenting Trade Errors

- Trade error databases
- Trade error forms (Cause, Details, Resolution, Enhancements to Prevent Recurrence)
- Electronic versus hard copy documentation

- Documentation of gain/loss calculation
- Documentation that client was made whole for a loss from an error
- Documentation showing that client was notified of error
- Documentation that business unit senior management was notified of error
- Documentation of e-mails and correspondence regarding error

Documenting Trade Errors



Duty to Disclose Trade Errors

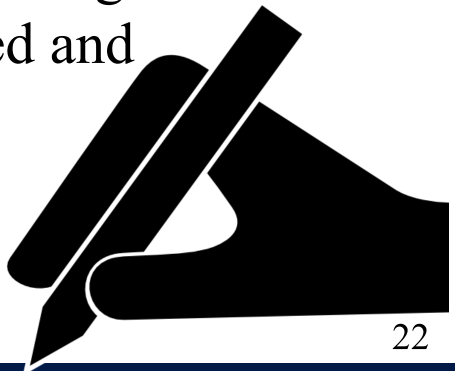
- Advisers must timely notify client of investment guideline breaches and violations of applicable laws and regulations
  - In case of sub-adviser, client means fund manager
  - Clients can also include insurance companies, board members of private funds and direct institutional entities
- Senior management is notified of trade errors upon discovery and resolution
- Regulatory Committees review trade errors and discuss trends
- Large trade errors reported to Risk Committees

Trade Error Procedures

- Provide examples of trade errors so employees can recognize what constitutes a trade error
- Designate someone who will be responsible for handling trade errors when they occur – generally the CCO
- Implement pre-trade controls to verify that orders are correctly entered and confirmed in accordance with instructions and restrictions
- Create and implement post-trade controls to screen for trade errors:
  - Portfolio manager or member of the portfolio management team will review trade reports daily and call to attention of appropriate portfolio manager and CCO any trades that appear to be erroneous

Trade Error Procedures

- Require employees to report trade errors as soon as practicable to CCO
  - Consider adopting guidelines as to the necessary magnitude of a trade error that is to be brought to the attention of firm's senior management, outside counsel and/or board
- Track reported trade errors to ensure that they are properly handled
  - Consider requiring employees to fill out forms documenting details of a trade error, including timing of trade error and when it was detected, reason it occurred and actions taken to remedy trade error

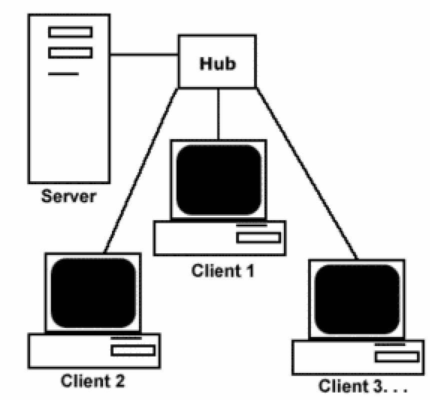


Trade Error Procedures

- Adopt measures designed to resolve trade errors. Possible approaches to resolving traded errors include:
  - In the case of a trade error that is discovered after execution of the trade, portfolio manager may avert error by reallocating the trade to other clients in appropriate circumstances

Trade Error Procedures

- Adopt measures designed to resolve trade errors. Possible approaches to resolving traded errors include:
  - Cancel the trade if possible
  - If the trade cannot be rectified through the market, another client or cancelled, calculate gains/losses resulting from trade errors and allocate gains and losses among affected funds and accounts



Trade Error Procedures

- When should clients be notified that an error has occurred within their account?
  - For all errors
  - For errors above a minimum threshold
  - Only when the client has suffered actual harm and needs to be reimbursed
- Document trade errors and how they were resolved:
  - Keep a record of all trade errors and how the firm resolved them
- Procedures related to disclosure of trade error policies to clients and investors