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August 13, 2012

RIA pays for enforcement case that questioned CCO's competence

Here's a key perennial lesson to remember: fix deficiencies found in a prior exam.

It's been stated many times before but received an exclamation point this month when the SEC fined an RIA \$35,000, forced it to hire a compliance consultant for two years and mandated the firm's website carry news of the freshly settled [enforcement case](#).

Consultiva Internacional, an RIA that manages \$694M in assets from Puerto Rico, fell prey for failing to heed that lesson. When examiners initially visited in 2005, they found "numerous deficiencies regarding its compliance program, including the design of the firm's compliance manual, the competency of its Chief Compliance Officer ... and inaccuracies and inconsistencies with its Form ADV."

Examiners also felt the CCO wasn't up to the task "due to his lack of familiarity with the Advisers Act and failure to obtain the proper training."

When examiners returned to the firm in 2010, they "found that Consultiva had not taken all of the necessary remedial steps to satisfy its compliance obligations" by failing to properly enforce the firm's code of ethics and not sufficiently doing and documenting annual reviews.

There has been a rash of cases citing CCOs recently ([IA Watch](#), April 23, 2012), including for failing to correct deficiencies found on earlier exams ([IA Watch](#), *CCO Competence, continued on page 5*)

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Hiccups with high frequency trading create market-wide risks

Knight Capital hasn't revealed exactly what happened Aug. 1 when "a technology issue" sent "numerous erroneous orders" to the **New York Stock Exchange**, sapping market confidence and generating the need for a \$400 million rescue of the market maker.

The SEC has been quick to act, scheduling a Sept. 14th "technology roundtable" to "discuss ways to promote stability in markets that rely on highly automated systems."

Wall Street attorney and industry gadfly **Bill Singer** called this latest cyber glitch "really somewhat frightening." **Irene Aldridge**, president of **AbleAlpha**, an RIA that uses high frequency trading (HFT), says it's possible that a firm using faulty software could "wreck the market."

Even more disturbing is the frequency of the instances. Last week the **Tokyo Stock Exchange** temporarily (*HFT Trading Risks, continued on page 4*)

Options beyond price and commission can aid fixed income best ex efforts

It appears as a constant challenge: how can you satisfy your obligation to seek best execution when transparency lacks in fixed-income transactions like a ship navigating a harbor saddled in fog?

"There's a lot that can be done other than price and commission," asserts **Greg Florio**, co-managing partner with **Orical** in New York. "You have to come up with a reasonable policy that relies on information that you can get."


When he worked in-house, Florio would weigh criteria, such as a broker's responsiveness, how it resolved errors or disputes and access to its top management, he says.



You also could toss in the volume generated with each fixed-income broker, their inventory, efficiency in selling hard-to-value securities, whether it offers the types of bonds you seek and the firm's reputation (has it been in the news lately for troubles?), contributes **Vicky Hogan**, (*Fixed Income Best Ex, continued on page 2*)


Fixed Income Best Ex (Continued from page 1)
 president of **NorthPoint Compliance** in Red Bank, N.J.

Gary Davis, VP of practice management at **Market-Counsel** in Englewood, N.J., recalls surviving five **SEC** exams while working in-house. He remembers that the SEC doesn't have specific rules on how you seek best execution. If you periodically conduct a best execution review, there's substance to these reviews and if you've kept documentation demonstrating you've made sound decisions, you should be fine, he says.

Smart to have a policy and test it

The SEC's [compliance rule](#)  encourages compliance policies and procedures around trading practices, "including procedures by which the adviser satisfies its best execution obligation." It also suggests compliance tests "that analyze information over time in order to identify unusual patterns, including, for example, an analysis of the quality of brokerage executions (for the purpose of evaluating the adviser's fulfillment of its duty of best execution)."

We've reported before that you have great flexibility in achieving your best ex obligations ([IA Watch](#) , March 12, 2012) and even shared 8-steps to use when transacting fixed income deals ([IA Watch](#) , June 30, 2008). Price alone need not be the only determinant in weighing best execution.

The [MMD scale](#)  benefits **Dan Trumbower at Trumbower Financial Advisors** (\$675M in AUM) in Bethesda, Md. He starts his mornings looking up U.S. Treasury rates and primary CD offerings. He also relies upon a network of six traders around the country who specialize in fixed income selection and who understand his criteria. He prefers smaller brokers, seeing them as more responsive.

"I'll take the market scale for a triple A rated municipal and I'll get quotes from all of my traders," Trumbower says. He compares the responses in Excel. He'll choose the broker that offers "the highest yielding security on a taxable equivalent basis."

His annual review includes an analysis of who he's buying from and an assessment as to whether his clients received good prices.

Documentation tips

You could devise a checklist upon which you judge best execution and use it in your best ex meetings, says Florio. Of course, be sure to do whatever your policy calls for. The minutes of these meetings should include the items your policy holds you to weigh, he adds.

How often you hold such meetings depends upon you. Davis has seen them held monthly, quarterly and even semi-annually. He recommends you take action if your analysis detects that you greatly overpaid for a security. Raise the issue with the broker, he says. There may be a reasonable explanation but you deserve one.

Poll your traders

Florio recommends an action he would take annually. Ask traders to rank the 10 most commonly used prime and introducing brokers based on criteria mentioned above, plus by type of security. He would aggregate the data and produce a ranking, which he would share with the traders. This improved their knowledge of the firm's list of pre-approved brokers as well made them aware of other brokers they could use.

The firm would pre-clear the use of brokers based on other criteria, including if they were properly registered and displayed no disciplinary history, says Florio.

Another way to detect the use of brokers is to period-
(Fixed Income Best Ex, continued on page 3)

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

Fixed Income Best Ex (Continued from page 2)

ically review e-mails. Florio would ask a trader if he spotted a spike in usage of a certain broker. He wanted to make sure gifts from the broker weren't swaying the trader over the interests of the client. ■

A reader suggested story

CFTC registration poses special challenges to fund of funds manager

One of the biggest questions emanating from the CFTC's elimination of a key exemption under its CPO and CTA rules relates to whether fund of funds managers should register if only underlying funds invest in commodities, swaps and currencies ([IA Watch](#) , July 30, 2012).

Many of these managers relied on scenarios addressed in guidance promulgated through Appendix A, which was directed at fund of funds, to skirt registration. However, that appendix disappeared when the CFTC in February rescinded [Rule 4.13\(a\)\(4\)](#) , which contained the exemption that allowed many advisers to avoid registering as a CPO or CTA ([IA Watch](#) , Feb. 13, 2012).

"It gets a little mushy," says **Jim Biery**, a partner with **Sidley** in Chicago, on what fund of funds managers should rely upon now. He says CFTC staffers have said Appendix A continues to be "a reference" until the agency releases further guidance – likely in the form of FAQs – which the Commission has been promising for weeks.

The problem intensifies because the deadline to register is Dec. 31 and it can take some firms months to complete the process.

"It's only guidance," says **Josh Sterling**, a partner with **Bingham McCutchen** in Washington, D.C., of Appendix A. The CFTC hasn't formally stated that Appendix A is dead so you could "theoretically rely on it."

A New York attorney passes on word from CFTC

staffers that an "Appendix D" is coming soon. However, he predicts it will not be as helpful for fund of funds managers as the old Appendix A.

The simplest solution, says the New York attorney, is to register as a CPO if your commodities business can't stay below two thresholds that trigger the need to register. It will be very difficult for these fund managers to look through to the underlying funds to see how much commodities exposure they hold, especially if the underlying funds are managed by overseas advisers who care little about the CFTC's rule change, the attorney states.

Registering may be the safest approach

While you may be able to find refuge in Appendix A, "you may ultimately determine that it's safer to register," agrees Sterling. You could try coming up with a side letter or another type of an agreement in which sub managers would pledge not to exceed commodities holdings beyond a certain threshold. This is a must if you decide not to register, says Sterling.


It may come without harm to cross the threshold once or twice, says the New York attorney, but more frequent transgressions risk a regulator backlash. It would take a rigorous "on-going, real-time compliance" system to be sure sub managers don't cause you to topple the threshold without being registered, he adds.

The CFTC can do a "special call," which essentially holds the fund manager to prove it fits within a registration exemption. Plus, a firm must annually attest that it continues to qualify for an exemption, says Sterling.

A fund of funds manager probably should register even if it doesn't directly trade in any currencies, commodities or swaps but serves as a limited partner investor in an underlying fund that does, says Sterling. The underlying fund would certainly register as a CPO.

The fund of funds manager may not have to register
(Fund of Funds, continued on page 4)

Are you an ERISA fiduciary?

Your first thought probably is yes. After all, investment advisers are fiduciaries. But ERISA is different. The plan sponsor is usually the fiduciary. However, there are criteria that could make you an ERISA fiduciary ([IA Watch](#) , Aug. 6, 2012).

There are three broad tenets that define an ERISA fiduciary, says **Jason Roberts**, CEO of **Pension Resource Institute** in Manhattan Beach, Calif. These are: **1.** Has discretion over the assets **2.** Has discretion over the plan (e.g., hiring and firing of service providers) and **3.** Provides investment advice.

That last criterion includes a 5-part test and you must answer "yes" to each part: **1.** Provides advice on the value of or advisability of investing in securities or other property **2.** Provides advice on a regular basis **3.** Acts pursuant to a mutual understanding **4.** That understanding serves as the primary basis for making investment decisions and **5.** The advice is individualized based on the needs of the plan or the participants. ■

Fund of Funds (Continued from page 3)

as a CTA, though, because it comes with more exemptions from registration, notes the New York attorney.

“I think [the CFTC is] going to be looking for fund managers who didn’t register and make a test case out of” them, predicts Sterling.

Editor’s Note: This is your last chance to get more guidance on CFTC registration by signing up for Tuesday’s **IA Watch** webinar [Registering with the CFTC: Compliance Guidance to Meet the Coming Deadline for CPOs and CTAs](#). Click [here](#). ■

HFT Trading Risks (Continued from page 1)

suspended derivatives trading due to a glitch, even while memories are fresh of troubles on the **BATS Exchange**, the **Facebook** IPO and the 2010 flash crash. The latter event caused regulators to impose circuit breakers during times of heightened market volatility ([IA Watch](#), June 21, 2010), which some credit with dampening the effect of Knight’s error.

Even if your firm doesn’t utilize HFT technology, you’re affected by it, says **Bernard Donefer** of the Subotnick Financial Services Center at **Baruch College** in New York. “All the markets are electronic,” he points out. “We’re all in the same pool together.”

Therein lie the risks and rewards, though. Donefer, who once oversaw the installation of HFT systems as a senior VP at **Fidelity**, predicts there will always be “glitches like this.” Recall the 1987 market crash. He tells of a similar crash in 1962 – long before computers ruled Wall Street.

A “bug” in Knight’s software caused the order surge, Donefer believes. He understands the firm released a new version to coordinate with the **NYSE**’s recent innovation permitting retail customers to price at sub-penny intervals.

The Jersey City, N.J.-based market maker has said little beyond a [press release](#) that announced that the

“software has been removed from the company’s systems.”

Singer worries that “technology is outstripping our ability to deal with it.” He brings up the failure of the power grid in India that put millions in the dark and wonders if a cascading failure like that could wrack the U.S. markets.

Don’t blame the technology but the herd mentality using it, counters Donefer.

What can be done about all this?

In June, the **Financial Information eXchange (FIX) Protocol**, an industry standards group, put out its [Recommended Risk Control Guidelines](#). The best practices “aim to systemically minimize the inherent risks associated with executing electronic algorithmic and direct to market (DMA) orders.” The practices include actions such as adding text to messages indicating why an order has been paused due to electronic volatility on the market and installing “runaway checks” to spot when a “client’s trading algorithm has stopped working correctly and/or is no longer under control of the client.”

New SEC action no doubt will follow next month’s roundtable. Last year Chairman **Mary Schapiro** spoke of possibly mandating two “Automation Review Policies.” These could mandate that firms conduct “regular capacity planning and testing exercises” and “system vulnerability assessments” as well as “undergo an annual independent review and notify the Commission staff of system outages and material system changes.”

It’s a wise best practice to hire an independent “software tester” who has “no vested interest” in your system to run multiple scripts designed to spot flaws before a system change goes live, recommends Aldridge. You can find these testers on [Monster](#), [Craigslis](#)t and other online resources. Testing your algorithm every six months makes sense, she adds.

No software system lacks at least one bug, she says. Her firm’s platform runs more than 100,000 lines of C++ code. It can take three years to construct such a program. The biggest mistake smaller firms make is to scrimp on testing. The big shops employ teams that do extensive testing, says Donefer.

Put the business analyst in charge of quality assurance, recommends Donefer. This person typically knows the most about the application.

Possible solutions

His solution would have each exchange monitoring for problems and ordering a halt to trading at the first

(HFT Trading Risks, continued on page 5)

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HFT Trading Risks (Continued from page 4)





sign of trouble. Another option is to cancel any trades that occurred from the start of the event and prior to settlement.

Aldridge prefers a solution built around the SEC stepping in and turning off trading during an event – but not in a market-wide, circuit breaker way but on an account-by-account basis. “It’s feasible now,” she contends, adding **FINRA** houses the necessary data.

Perhaps the SEC could require a “national server farm” that would coalesce each exchange’s off-site backup, says Singer. When a flaw strikes one system, the switch could in effect reboot the markets, he imagines.


“It’s bound to happen again,” predicts Aldridge. “It’s a very new field still.” She adds that next year should bring new tools to flag market glitches – “like a warning” – allowing firms to stop trading until the madness subsides.

SEC inquiring of firm codes

A Texas attorney tells of SEC examiners asking firms to “surrender” their HFT codes. This is a topic that predates the Knight issue. The [AXA Rosenberg case](#)  ([IA Watch](#) , Sept. 26, 2011) touched off this activity. The **CFTC** and SEC subpoenaed data from high frequency traders following the flash crash in 2010 ([IA Watch](#) , June 28, 2010). And we’ve reported that examiners may ask for a white paper or synopsis but generally not a firm’s entire code ([IA Watch](#) , Oct. 24, 2011).

Aldridge wouldn’t want to share her firm’s code. She doubts examiners could really get much out of it but fears that an enterprising but ethically challenged agency official could quit the Commission, take the firm’s code, return to the industry and use it. “Nothing can stop him from doing that,” she says.


Could you code leak out?



The agency has hired new specialists that have backgrounds in high frequency trading ([IA Watch](#) , April 2, 2012). However, a former SEC official tells **IA Watch** the Commission has strict rules on what a departing employee can take and investigative materials gleaned from exams wouldn’t be allowed to go with the worker.

The official couldn’t speak to whether the agency would consider a firm’s entire HFT code a required book and record but she shared the viewpoint on the question when she worked at the Commission. Yes, it would be considered a book and record and subject to an examiner’s request for production, she says. ■

Your policies and procedures can help keep you from being termed a supervisor



Use your P&Ps to stress that the CCO has many responsibilities but has a reduced role as a supervisor if you have concerns your work could heighten your risk of facing a potential failure to supervisor charge.



Nancy Lininger, a consultant with **The Consortium** in Camarillo, Calif., recommends your policies and procedures establish a chain of command. You could write a policy around supervision (she shares a [template of one](#) ) that gives the CCO “full responsibility and authority to develop and enforce” the P&Ps but confines any role of supervision to compelling staff to follow the firm’s P&Ps, she says.

Her suggestion comes as the words of **SEC** Commissioner [Daniel Gallagher](#)  echo that as a compliance officer becomes “more engaged” at the firm “the more likely they are to be deemed to be playing a supervisory role.” He made his remarks after the Commission dismissed a failure-to-supervise charge against former GC **Ted Urban** this winter ([IA Watch](#) , March 5, 2012).

Your policy should name the CCO and the firm’s supervisors and outline “the specific activities” that each would be responsible for, says Lininger.

P&Ps for social media

She also recommends your policies and procedures for social media explain acceptable and non-acceptable uses of business-related postings following OCIE’s [exam alert](#)  ([IA Watch](#) , Jan. 9, 2012). Treat such posts as advertisements because they’re generally communications directed at more than one person. Require pre-approval and cross reference your social media policy with its advertising and marketing counterpart, Lininger recommends.

Editor’s Note: Come hear Ted Urban speak about his experiences and lessons for other CCOs at [IA Watch’s IA Compliance Fall Conference 2012](#)  in Philadelphia on Sept. 24th. Find out more and register [here](#) . ■

CCO Competence (Continued from page 1)

Dec. 5, 2011).


Consultiva “began taking steps to rectify” its problems last year. For instance, it has hired a compliance consultant and is implementing its recommendations.

The firm’s CCO, **Edmundo Garza**, declined comment. The firm’s CEO, **Myrna Rivera**, says the RIA has made significant changes and is “satisfied with the
(CCO Competence, continued on page 6)

CCO Competence (Continued from page 5)

results” of the case. The firm hired a New York firm to do continuing education and sent the CCO to conferences, instituted a risk assessment process focused on its business model, created a compliance committee “that meets rather frequently” and set up a compliance calendar to guide the operation.

The case presents another lesson for other RIAs, according to Rivera. You can’t “over-emphasize ... the need to have a competent and committed compliance culture,” she says.

The settlement dictates that the firm must “prominently” display news of the settlement on its [web site](#)  for one year. ■

FINRA sweep letter could inform SRO’s efforts for ADV-type disclosure document


FINRA CEO **Richard Ketchum** has repeatedly stated that firms are going to need to identify their significant conflicts of interest and figure out how they’re going to manage them. That warning was followed up recently with a sweep letter that asks recipients about their conflicts, and for them to indicate when FINRA staff can spend about three hours with senior management to discuss the firm’s approach to conflicts.

“It’s scary on the one hand and understandable on the other,” said a CCO from a New York broker-dealer that didn’t receive a copy of the letter from FINRA but who read the contents online. “Many people have just been paying lip service regarding conflicts, so I guess FINRA wants to make sure. I can guarantee that there are lawyers being called all over the country to meet with executives to prep them prior to any meeting with FINRA. If anyone has not yet set procedures and prepared notifications, I guess it’s time they did.”

FINRA might be collecting information as follow-up to a “concept release” it issued in 2010 about the idea of B-Ds providing a disclosure document to their retail customers at the start of their relationship. The idea was to think of creating a document — perhaps similar to the ADV that investment advisers use — that would describe the types of services and products the firm offers, and the conflicts associated with those services.

The letter asks for a summary of the significant

conflicts the firm is managing and more. ■

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