Dealing with Investment Errors

Presentation to FIRMA's 35th Annual Fiduciary Risk Management Conference

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May 3, 2022

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Presenter

Ashley Rodriguez, Associate, regularly counsels investment advisers and other financial institutions in regulatory, corporate and compliance matters. Ms. Rodriguez advises clients on a variety of topics related to formation of new advisers, changes in control, registrations, regulatory filings, compliance policies and procedures, investment advisory agreements, marketing and disclosure obligations. She regularly counsels advisers to private funds, advisers providing electronic investment advice, quantitative asset managers, managers specializing in alternative asset classes such as collateralized loan obligations (CLOs) and real estate and managers trading in derivatives. Ms. Rodriguez also has extensive experience representing clients in SEC examinations and experience seeking exemptive and no-action relief from the SEC staff.

Prior to law school, Ms. Rodriguez worked for more than five years in financial services for an investment adviser and held a Series 6 FINRA license to sell Mutual Funds and Variable Annuities.

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Agenda

- Legal framework
  - Standard of conduct
    - Investment Advisers Act of 1940 (“Advisers Act”) and related guidance
    - State law fiduciary duties
    - Contractual and organizational documents and “hedge clauses”
    - *Note*: Other regulatory regimes and standards can apply, and these rules can be different and stricter (e.g., ERISA accounts)
  - Guidance on investment errors and calculating related losses
- Role of policies and procedures in resolving errors
  - Identifying and defining “investment error”
  - Remedying a potential issue, and mitigation
  - Evaluating sources of liability
  - Calculating an appropriate reimbursement amount
  - Resolving and informing stakeholders (e.g., GIPS)
  - Disclosure related to such errors
- Takeaways

Legal Framework

Standard of conduct – Advisers Act and foundations of fiduciary duties

- Advisers Act and Supreme Court precedent
  - The Advisers Act contains antifraud provisions
  - As explained by the Supreme Court in *Capital Gains*, the Advisers Act "reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship'" and "a congressional intent to 'eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser -- consciously or unconsciously -- to render advice which was not disinterested.'" *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (citing both the Advisers Act and state law)
- Fiduciary duties are a creature of SEC interpretive guidance and state/common law principles
  - Neither the Advisers Act nor the SEC's rules thereunder explicitly state or define any fiduciary duties for investment advisers
  - Rather, as agents, advisers have a duty to their principals (i.e., their clients) under state/common law
  - Even so, the SEC has long interpreted the antifraud provisions of the Advisers Act and Supreme Court precedent to confer fiduciary duties on advisers toward their clients, or at least to imply a duty to fully and fairly disclose conduct (including material facts) that may not be consistent with those fiduciary duties

Standard of conduct – SEC IA Standard of Conduct Interpretation

- Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Interpretation, SEC Rel No. IA-5248 (effective July 12, 2019) (IA Standard of Conduct Interpretation)
  - The IA Standard of Conduct Interpretation applies to SEC- and state-registered advisers, advisers that are exempt from registration and advisers prohibited from registering, and states the SEC's views that
    - The Advisers Act establishes a federal fiduciary duty for advisers, and that this duty is based on equitable common law principles
    - The scope of such duties, and explains its two primary components:
      - Duty of Care: Requires an adviser to serve the best interest of its client and
      - Duty of Loyalty: Requires that an adviser must not subordinate the client's interest to its own interests, which includes full and fair disclosure of material facts related to the advisory relationship
    - An adviser's fiduciary duty is enforced through Section 206 of the Advisers Act, which includes general anti-fraud provisions

Standard of conduct –SEC IA Standard of Conduct Interpretation (continued)

- Scope and application of duties
  - The SEC acknowledged that the contours of the adviser/client relationship determine how the fiduciary duty applies to that relationship, and that the relationship can be shaped through the advisory contract and disclosure
- "Hedge" clauses
  - Exculpation clauses that limit liability in an advisory agreement or fund organizational documents, which generally specify a standard of conduct, which is often "gross negligence"
  - SEC withdrew no-action letter that addressed the use of "hedge clauses" (i.e. limitations of the adviser's liability) in advisory agreements, stating there were "few (if any) circumstances" where such a clause would be appropriate with a retail client
    - Potential to mislead clients to believe that a cause of action is unavailable
    - Validity of such clauses depends upon all of the facts and circumstances

Standard of conduct – “hedge clauses” – SEC Risk Alert and Proposed Rule

- SEC Division of Examinations, Risk Alert, Observations From Examinations of Private Fund Advisers (Jan. 27, 2022) (Risk Alert)
  - The staff of the Division released an update to a 2020 risk alert published in respect of private fund advisers discussing the staff’s observations and findings from the Division’s examinations, which the Division published to provide “additional observations”, including the “*use of potentially misleading ‘hedge clauses*.’” (Emphasis added)
  - The Risk Alert continues to build on the SEC’s view of hedge clauses as potentially misleading, and explains that the Division’s staff has observed “potentially misleading hedge clauses in documents that purported to waive or limit the Advisers Act fiduciary duty except for certain exceptions, such as a non-appealable judicial finding of gross negligence, willful misconduct, or fraud. Such clauses could be inconsistent with Sections 206 and 215(a) of the Advisers Act.”
- Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Proposed Rule, SEC Rel. No. IA-5955 (Feb. 9, 2022)
  - Prohibit an adviser from “[s]eeking reimbursement, indemnification, exculpation, or limitation of” an adviser’s liability “for a breach of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness in providing services to the private fund.”

Investment errors – SEC guidance

- The Advisers Act does not contain any specific provisions defining or addressing an adviser's responsibility for "investment errors", breaches of investment limitations imposed by the federal securities laws or for violations of a client's investment guidelines

- In the adopting release for Advisers Act Rule 206(4)-7 (the "Compliance Rule"), the SEC does not specifically discuss investment errors or error correction policies, although such policies would arguably be part of policies necessary to address: "[p]ortfolio management processes" and "[t]rading practices". Compliance Programs of Investment Companies and Investment Advisers, SEC Rel. No. IA-2204 (Dec. 13, 2003)

- The SEC has stated in an enforcement action that an adviser should have policies and procedures to address trade errors
  - The SEC sanctioned an adviser and a related person for willfully violating Section 206(1) and (2). Here, the adviser did not have a policy regarding trade errors, and allocated an inadvertent trade that resulted in a loss to client accounts contrary to "industry practice and an investment adviser's fiduciary duty to its clients, losses caused by an investment adviser's own trade error were the responsibility of the adviser and should not be borne by clients" and then concealed the trade error. *See e.g., In the Matter of Michael T. Jackson and EMG Capital*, SEC Rel. No. IA-2374 (Apr. 6, 2005)

Investment errors – SEC Risk Alert

- SEC Division of Examinations, Risk Alert, Observations From Examinations of Advisers that Provide Electronic Investment Advice (Nov. 9, 2021) (Risk Alert)
  - The staff of the SEC's Division of Examinations (Division) released a Risk Alert discussing the staff's observations and findings from the Division's recent electronic investment advice initiative, which include (as most relevant here):
    - Portfolio management – oversight. The staff stated that "many" advisers did not test their platform's investment advice for alignment with the "clients' stated or platform-determined investment objectives or otherwise satisfying their duty of care." Specifically, the staff observed advisers that (as most relevant here):
      - Lacked or had insufficient written policies and procedures to ensure adequate oversight and supervision of their automated platforms, which increased the risk of "algorithms producing unintended and inconsistent results" (e.g., coding errors, rebalancing errors, trade errors, "coding insufficient to address unforeseen or unusual market conditions")
    - Portfolio management – disclosures and conflicts. The staff observed that "many" advisers' Forms ADV included inaccurate or incomplete (or omitted altogether) disclosures regarding (among other matters) conflicts of interest and investment and trading practices
      - Specific examples of omitted, inaccurate or incomplete disclosures included occasions where advisers did not disclose the adviser's treatment of trade error profits and losses
      - Further, the Risk Alert notes that "more than half" of examined advisers' advisory agreements, terms and conditions or other documents included hedge clauses or other exculpatory language that could be inconsistent with advisers' fiduciary duties

Investment errors – SEC Risk Alert (continued)

- Staff recommendations for improving compliance
  - Routine testing of algorithms to ensure they are operating as intended. The staff recognized advisers that performed algorithm-related testing at least quarterly, noting that it had observed certain commonly employed practices, including:
    - Testing performed by algorithm designers/software developers that included additional teams (e.g., portfolio management, compliance either working independently or relying on other groups, internal audit, information technology);
    - Exception reporting or other reporting mechanisms that combined “high-level and account-specific results” that “often” were reviewed by algorithm designers/software developers; and
    - Compliance issues where “many” firms also included reviews by portfolio management or information technology
  - Safeguarding algorithms. The staff found that “most” advisers sought to prevent unauthorized algorithm changes by limiting access to relevant code to certain personnel and providing advance notice to compliance staff of “substantive algorithm changes or overrides.” While advisers using “white label” platforms generally could not modify underlying code, many reported that the platform providers furnished notice to advisers of any changes

- While the initiative and Risk Alert each focus on the practices of advisers offering robo-advisory services, the Risk Alert also draws attention more generally to the “significant increase” in advisers providing electronic investment advice through other business models

- We note that the SEC staff has pursued actions against quantitative investment managers and others for “model errors”, and these are generally beyond the scope of this presentation

Calculating losses of an investment error – Lerner Letter

- In connection with an investment error, the SEC staff has stated that an investment adviser's fiduciary duties under federal law mean that, assuming the adviser has violated its standard of care and, even more important, assuming an actual "error" has occurred, the adviser "is responsible for any losses resulting from an inaccurate or erroneous order placed for an advised account." Charles Lerner, SEC No-Action Letter (pub. avail. Oct. 25, 1988)
  - This language should not be read to imply a regulatory standard of absolute liability for all investment adviser errors – regardless of the origin or circumstance – that may lead to a client loss
- It is well established that a fiduciary is not liable for all mistakes in which it may have played a role that result in a client loss. Ultimately, whether an adviser has a legal obligation to reimburse an account for a loss to which an investment error has contributed will turn on an analysis of the facts and circumstances
- A threshold consideration in this analysis is whether the investment error caused the account to incur any losses. Although the SEC has not established a method for calculating reimbursement amounts when an investment adviser commits a trading error, courts have generally allowed investment advisers to net gains against losses in certain circumstances
  - Courts have allowed netting when damages flow from the same error and the adviser acted in good faith
  - However, the SEC staff has nevertheless sometimes objected to netting

Role of Policies and Procedures in Resolving Errors

Identifying and investigating an "investment error"

- Typically, a policy will suggest monitoring of trade logs and that employees that become aware of a potential error contact the CCO
  - An adviser's Code of Ethics will also require that supervised persons report any suspected violations of the federal securities laws, and can specify other standards and reporting mechanisms, including escalation of such reports
- Upon discovering a possible error, an investment adviser should gather as much information about the situation as possible. Initial questions the investment adviser may want to consider when determining whether an error has occurred include the following:
  - What actually happened (that is, describe the facts and circumstances surrounding the error and attempt to identify the source and cause of the error)?
  - Is it truly an error or is it something else (for example, market action, or force majeure)?
  - Is the investment adviser or its supervised persons solely responsible for the error or was it caused by, or contributed to by, actions of a third party?
  - Was the error a result of the investment adviser's investment decision making or did it relate to transaction processing, trade allocation or some other administrative or operational aspect of the investment adviser's implementation of its investment decisions?

Defining "investment error"

- The terms "investment error" and "trade error" are not defined in the Advisers Act or under other applicable law. Accordingly, an adviser should establish a workable definition and process for identifying and addressing errors in an appropriate and consistent manner
  - An "investment error" is generally understood to mean a breakdown in the investment process that both violates the applicable standard of care and results in a mistaken investment
  - As such, a "trade error" is a subset of investment errors, and is thus illustrative of an "investment error", and the basis of many procedures
- In general, procedures broadly define "trade error" to mean a transaction that is determined to be (i) an unintended transaction for a client account (ii) that is in breach of the applicable standard of care (iii) which results in a financial gain or loss for the client, and can include:
  - The wrong instrument is purchased or sold;
  - The wrong quantity of an instrument is purchased or sold;
  - A purchase is made instead of a sale or a sale is made instead of a purchase;
  - An instrument is purchased or sold in violation of regulatory or contractual obligations (e.g., without a necessary approval); or
  - Trade misallocation

Defining “investment error” (continued)

- Typically, a procedure does <u>not</u> define the following as a “trade error”
  - Investment ideas that perform poorly (this is well understood)
  - Scenarios that do not result in a trade
  - Some policies address and do not define guideline breaches as a “trade error”, for example, “violations of any prohibitions, limits or any other guidelines if (i) such violation is curable and (ii) it is cured violation within thirty (30) days after becoming aware of the violation”
- Additional topics a procedure might address
  - Some policies address delayed execution
  - Some policies address coding errors in an algorithm and or other quantitative model, which could be treated as either an “investment error” or as an “incident” (defined as a “situation that results from failures in internal processes, people or systems, such as other routine processing errors or major systems failures”) depending on the facts and circumstances

Remedying a potential “investment error” and mitigation

- Policies can indicate that personnel will seek to remedy a potential issue before trade settlement
- However, if a broker-dealer is unable or unwilling to reverse the unsettled trade, an adviser could choose to correct transactions that have not yet settled through a proprietary error account
  - Consistent with the legal principles applicable to “netting” described below, it may be reasonable for the adviser to utilize any gains realized upon the disposition of the security to offset losses associated with the same error or a series of related errors. Gains that are not used to offset losses should benefit the client
  - Usually, these policies specify that any net gains are periodically donated to charity to avoid the impression that the adviser benefits from error corrections
  - We note that the use of an error account could potentially implicate certain prohibitions under the Advisers Act and other federal securities laws
    - Advisers Act Section 206(3), in relevant part, makes it unlawful for an adviser to knowingly purchase any security from a client as principal without disclosing to such client in writing before the completion of the transaction the capacity in which the adviser is acting, and obtaining the consent of the client to such transaction
- Policies can also address that they will seek to mitigate a trade that has settled

Evaluating sources of liability

- If it is determined there is an inadvertent trade, then the adviser would next seek to determine if their actions breached the applicable standard of care
- To evaluate liability, look first to the advisory agreement with and organizational documents for the client account
  - If these are with an investment adviser, it is possible that standard acknowledges duties owed by the adviser and uses a "best interest" standard based on the Advisers Act
    - Special considerations depending on account type, including ERISA's prudent person standard
  - However, there could be contractual limitations of liability to modify this, i.e., hedge clause
    - For example, "investment adviser is not liable for any act or omission in connection with providing services under the contract absent willful misfeasance, bad faith, gross negligence or reckless disregard of its obligations or duties"
      - In this case, the investment adviser would be liable for an investment error only if the error resulted from a breach of the standard of care, that is, gross negligence or more culpable conduct
    - For example, a contract could also seek indemnification from the acts/omissions of others
      - Carve out other service providers and other advisers sharing management of account
      - Carve out brokers/dealers from any concept of responsibility as adviser's "agents" (compromise: responsibility for due care in selection of broker)
- To determine an investment adviser's liability for losses, if any, one should look to the terms of its advisory agreement with its clients and the applicable state common law duty of care
  - Consider the facts and circumstances, and the application of these concepts from the law of contracts and negligence

Calculating an appropriate reimbursement amount

- If the adviser determines that there is an inadvertent trade that has breached their standard of care, then they might have an "investment error" that could require reimbursement (e.g., it resulted in a loss)
- SEC has not issued rulemakings or guidance specifically addressing loss calculation methodology in the context of investment adviser's investment errors
  - Other federal securities laws have generally limited recovery to actual damages
- An adviser's policy could look to trust law for possible methodologies to calculate a reimbursement, including:
  - "Total return" approach: Courts have applied this approach which seeks to put the account holder in the position they would have been had the wrong not been committed (e.g., performance between two accounts where one does not contain the error or where one contains an alternative appropriate investment)
  - Netting losses against gains: Courts have generally permitted this approach where (i) an error relates to a single transaction or series of closely related transactions/occurrences and (ii) the adviser acted in good faith
  - Opportunity cost: Courts have more sparingly applied this approach which seeks to reimburse for losses plus a reasonable measure of opportunity cost for the misdirected capital (e.g., factoring in returns of an index over the period); note that it is common to disclaim responsibility for losses that are uncertain or speculative
- Some error procedures apply a materiality threshold for reimbursement (e.g., errors that give rise to losses that are below a specified amount are not required to be reimbursed)
- Some error procedures explicitly exclude the tax implications for, or the tax status of, any affected client in calculating the amount of reimbursement

Resolving and informing stakeholders

- If the investment error resulted in a gain, then a procedure could let that accrue to the account. If an investment error resulted in a loss, then it will be reimbursed per the advisory agreement and the firm's procedure
- Upon determining there is an investment error that requires reimbursement, the adviser would want to confirm whether a third-party was involved in the matter
  - Typically, an adviser would seek to hold such third-party responsible for the reimbursement of any losses attributable to a client as a result of such trade errors. However, in the event that any third-party does not reimburse the client for trade error losses caused by the third-party, the client shall generally bear the loss, subject to applicable law and the advisory agreement
- Procedures can address that the CCO will document relevant facts and circumstances surrounding trade errors, including any resolution, remediation and calculations of impact in an error report maintained in line with applicable recordkeeping requirements
  - We note that it is typical for policies to address that the CCO or Legal is responsible for these records, and can involve legal counsel
- A policy would also establish who communicates with clients, when clients are informed, and what they might (or might not) communicate, and whether any other stakeholders need be informed
- If a firm claims GIPS compliance, we note that a GIPS manual will address error correction with GIPS compliant presentations, which would need to be separately followed

Disclosure related to “investment errors”

- Disclosure could be placed in an offering document, advisory agreement or Form ADV related to resolution of investment errors, including in the placement, processing, and settlement of trades
- Disclosure could
  - Explain that the firm takes reasonable efforts to place trade accurately, but that errors can and do occur, and define an “investment error” or “trade error”
  - We note that if there is complex, high volume, or trading in novel instruments, some advisers explain this risk
  - Address effects of an error (e.g., can result in losses or gains)
  - Explain how such an error would be resolved (e.g., client will be “made whole”; losses and gains will be born by the account; account will only be reimbursed for any losses resulting from the firm’s breach of the applicable standard of care (generally gross negligence or willful misconduct)), and that the firm has a relevant procedure
  - Address whether the firm assesses and seeks reimbursement from third-parties (e.g., brokers) or counterparties, and explain there is a conflict because of the business relationship and costs to pursue a claim
  - Explain that the firm determines in its sole discretion whether an error has occurred, and whether it breached the applicable standard of care and a reimbursement amount, if any, and the firm has a conflict in making this determination

Takeaways

A look ahead

- The SEC is using its administrative powers to try to push the broader investment advisory industry toward a standard of care based on reasonableness/negligence
  - Comments on organizational documents in 1940 Act fund registration process
  - Proposal to prohibit private fund advisers from seeking indemnification or exculpation for negligent conduct
- It remains to be seen how the IA Standard of Conduct Interpretation would be treated by a federal court, because no adviser has (yet) challenged it
- Investment advisers now have a higher degree of reliance on technology, data, models, automation and third-party service providers in their investment and trading processes, and with this increased reliance, comes an increased risk for errors

Takeaways

- Consider any use of models or automation in your investment and trading processes, and relationships with third parties
  - Consider the services and limitations of liability in respect of relevant service provider agreements
- Review standards of care in client agreements
- Policies and procedures
  - Consider adopting an error procedure with guidelines that provide a framework for establishing:
    - Standard of care
    - Whether breach occurred
    - In the event of breach, what resolutions to pursue, including, if appropriate, reimbursement, and communicating with clients
  - Review Code of Ethics for any descriptions of reporting violations or errors, and conform accordingly
    - In addition to the required reporting of potential violations of the federal securities laws, some codes explain reporting and escalation of potential errors
- Review disclosure and consider revisions as necessary to describe your practices, policies and error resolution, and any reliance on third parties for related services

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