ASSETTE

Communicating Error-Free Investment Results

How automation can minimize operational, regulatory and reputational risks in investment management marketing

Prepared with input from Richard Kerr of K&L Gates LLP
and Amy Jones, CIPM, of Guardian Performance Solutions LLC

8/10/15

The investment management industry has automated almost every aspect of its operations over the last several decades: portfolio accounting, performance calculation, pre-trade compliance, order management and trading, analytics, CRM and, more recently, portfolio risk modeling.

But when it comes to pulling all this data together into cohesive presentations for existing and prospective clients, most investment managers are still operating in a 20th century tech environment, relying on a hodgepodge of spreadsheets and manual calculations to create and publish the data they use in their marketing and reporting materials.

The Last Mile Problem

We call this the “last mile” problem, and it’s a big one. By failing to automate the last mile in order to create holistic, error-free marketing and client materials, investment managers leave themselves open to a variety of very real and potentially expensive risks in precisely the part of their reporting process that prospects and clients — and ever-vigilant regulatory watchdogs — focus on. And why do regulators zero in on marketing and reporting material? Because investors rely on the data in these presentations to make investment decisions and because investment advisors have a duty to provide investors with accurate information.

In this paper, we take a hard look at that last mile problem: how it manifests itself in most investment firms; the operational, regulatory and legal, and reputational risks it poses; and how managers can use technology to fully automate their marketing materials and reports, and generate error-free communication of investment results.

“Good Enough” isn’t Good Enough Anymore

Most investment management firms automated their operations as relevant technology became available for various “silos” such as trading, accounting and performance measurement. But those technologies weren’t always fully integrated or able to “talk to one another.” In order to present holistic investment results to prospective clients, investment managers need to combine data from all these disparate systems to produce cohesive marketing presentations, and much of that process is done manually. For example, printing reports from each silo and manually typing the data into marketing materials is still quite common. At certain firms, data is downloaded into spreadsheets and then linked into presentations. While this is a safer approach than typing, it still leaves the manager vulnerable to human error.

In addition to quantitative data, presentations often include qualitative insights from portfolio managers regarding reasons for purchasing or liquidating positions, or over – or underweighting a particular sector. These comments are of great interest to existing and potential clients, as they put meat on the bones of the performance data, and are often a key differentiator in competitive sales situations.

For those firms who claim GIPS compliance, most performance calculations have been fully automated for some time. But their processes for maintaining composites, preparing GIPS statistics and updating their Compliant Presentations (CPs) are still a combination of manual, semi-manual and automated steps. For example, many midsized firms use their portfolio accounting software for composite maintenance, but calculate statistical data in spreadsheets and update GIPS disclosures by hand. And while larger firms tend to use specialized composite management systems that calculate statistics and produce disclosures, incorporating GIPS material into marketing presentations still involves manual work and is far from seamless.

Since the process isn’t perceived as “broken,” in many cases, it hasn’t been fixed.

To Err is Human

Anytime there are human touch points involved in calculating, combining or updating performance information, there is potential for error. Using a layer of spreadsheets to house underlying data and then linking presentations to the spreadsheets may seem like a perfectly reasonable automated solution at the outset, but it has been our experience that over time these processes tend to fall apart. Spreadsheets and presentations are constantly changing, and every manual update to a spreadsheet is an error waiting to happen. In fact, a broken link or wrong cell reference in a formula is more likely to go undetected than a manual error due to the false sense of security quasi-automation provides.

And then there's the "recycling" problem. Once performance information is generated, the data is often used to feed multiple types of marketing materials and reports — each of which may have its own combination of automated, semi-automated and manual processes. For example, a firm may use desktop publishing software to generate fact sheets and white papers, and presentation software for introductory and final sales presentations, and spreadsheets to upload performance information into consultant databases. Without automated safeguards in place, it's easy to see how non-compliance-approved or outdated information can slip into a marketing document or client report — and the hands of regulators.

Multiply this by the sheer volume of inputs that go into a typical investment management presentations and the risk exposure rises. Most firms rely on a portfolio accounting system, one or more internal and/or external analytics and attribution systems, and several spreadsheets to produce marketing information and reports. Certain data is taken directly from these systems, while various spreadsheets calculate items such as assets by client segments, investment vehicles and even GIPS statistics. In addition, qualitative information from portfolio managers must be sourced and woven into the final presentation material.

While checklists, peer reviews, vigilant compliance oversight and standardizing materials can reduce human errors, it is impossible to eliminate them, leaving investment managers vulnerable to operational, regulatory and reputational risks.

Operational Risk

In a speech delivered in December 2014,[1] SEC Chairperson Mary Jo White said, "…by 'operational risk,' I generally mean risk from inadequate or failed internal processes and systems." Operational risk includes all errors that can occur in the normal course of doing business, be it setting up new accounts, trading securities, reconciling data, producing client reports or generating information for sales purposes.

Some examples of common performance-related operational bloopers include:

- **Copying return numbers into the wrong return period column.**
  It doesn't take much to copy a 3−year composite return number from a spreadsheet into the 5−year return column in a presentation or manager database. This common type of cut-and-paste error is easy to make and hard to catch.

- **Failing to include required regulatory disclosures in sales materials.**
  While this can — and does — happen to all types of investment management firms, those claiming GIPS compliance are doubly vulnerable here. When it comes to GIPS errors, the offending firm can be required to redistribute the corrected CP slide to current and prospective clients who received the original, which exposes the firm to reputational risk. Trust us when we say that no firm wants to go through that process!

- **Using an existing marketing pitch book as the template for a different strategy presentation.**
  A simple copy-and-paste error can result in the wrong benchmark information being displayed in

the new sales pitch book. Let's say a firm uses their Small-Cap Core pitch book as the template for a Small-Cap Growth presentation. It's easy to copy-and-paste Small-Cap Growth returns into the existing document but forget to change the benchmark name — and/or data — from the original Russell 2000 Index to the correct Russell 2000 Growth Index.

While a single mistake resulting from "fat fingering" a performance number or a broken link in a spreadsheet probably won't lead to regulatory sanctions or enforcement action, a series of such mistakes could signal broader issues with the firm and its operations. Operational issues are of keen interest to regulators since sound operations form the foundation for accurate marketing communications and client reports. If the firm lacks robust controls, they invite regulatory scrutiny. And, by definition, a high level of operational risk opens the firm up to regulatory risk.

Regulatory and Legal Risk

While no investment management firm we know would ever willfully misrepresent information to gain a marketing edge, unintentional mistakes can creep into marketing materials and invite additional scrutiny. The regulatory climate has changed in the post-Madoff era; unfortunately, a few bad apples have upset the entire cart!

Examples of performance-related regulatory missteps include:

- **Changing the time periods of returns presented.**
  If a firm uses different time periods each quarter — for example, presenting 1−year, 3−year and 5−year returns in Q1, and then presenting 1−year, 3−year and 7−year returns in Q2 — it could be deemed misleading. To avoid running afoul of regulators, firms must have policies that address and identify a baseline of mandatory performance periods that must be included in every presentation. With such policies in place, regulators may look more kindly on the inclusion of the different time series in the presentation.

- **Inadvertently including the wrong GIPS information.**
  For investment management firms who claim GIPS compliance, regulators are very specific about what type of composite performance information and disclosures must be included in marketing materials. They look closely at composite data to verify that GIPS-compliant firms are including all required statistics, updated at least annually, for all marketed composites. When marketing materials, strategy fact sheets and website pages are updated manually, it is easy for unintentional mistakes to slip in unnoticed. A common example is to inadvertently copy the GIPS statistics for one composite into materials designed for a different composite strategy.

- **Cherry-picking past specific recommendations to add color to a performance track record.**
  If a firm unintentionally shows only the top performance contributors and not the corresponding performance detractors, it will be in violation of SEC regulations.

Fiduciary Standards

Investment managers operating under the Investment Advisers Act of 1940, ERISA and other applicable federal law are fiduciaries. As such, they have specific legal responsibilities. One is a "duty of care," which includes employing reasonable care to avoid misleading clients. According to attorney Lorna A. Schnase, "calculating performance with due care when preparing marketing materials, pitch books, website presentations and other materials provided to clients and prospective clients" is an example of one area where the "duty of care" fiduciary standard comes into play. And while the traditional legal benchmark for what constitutes "due care" has been what "similar people, similarly situated" would have done — a fancy way of saying industry norms — Schnase comments that "… it is not necessarily enough to prove merely that an adviser adhered to industry custom or practice to avoid liability for breach of its duty of care. Rather, it is just one factor to be considered." [2]

To put it bluntly: In today's aggressive regulatory climate, "that's how everyone does it" is not enough to exonerate an investment manager who accidentally typed the wrong performance number into a marketing or client presentation as they headed out the door. At the very least, industry best practices are likely to be the "new normal," and if better processes were available, it will be incumbent on the firm to explain why they were not employed.

A More Aggressive SEC

The SEC has widely publicized its data analytics capabilities, including forming specialized units that can analyze mountains of data using very sophisticated software. The SEC continues to increase the volume of data required from investment managers through rulemaking related to regulatory reporting.[3] It appears that the SEC seeks to build a mosaic of each firm, and firms want their mosaic to appear clean and intact. Should the SEC knock on your door, it's in your firm's best interest to show operational efficiency, internal controls and a solid culture of compliance.

Any action by regulators, even mere investigation with no enforcement action, can tarnish a firm's reputation and raise red flags for prospective clients. Consultants who monitor investment managers are quick to drop a firm from their recommended lists at the slightest whiff of impropriety.

In addition to potential fines and sanctions, regulatory risk can affect new business revenue and existing client relationships far into the future.

Reputational Risk

Both operational risk and regulatory risk lead to reputational risk. If current or prospective clients see errors in reports or marketing materials, or if regulators take note of these mistakes, it will affect the firm's brand and reputation. For example:

- **It's bad when a portfolio manager notices an error in mid-presentation.**
  If a portfolio manager or sales professional notices that the displayed benchmark is wrong while in the midst of a presentation, it can throw them off and impede their ability to tell an effective story.

- **It's even worse when the client notices.**
  Worse yet, if a trustee or consultant in the audience notices the error, it can lead to a series of embarrassing questions that are sure to derail a well-thought-out presentation. While the error might not be a fatal one, its very presence undermines trust in the firm's ability to deliver superior services.

- **The worst case is when the client notices, but doesn't say anything.**
  In this situation, the manager loses the business and never knows why. The firm goes on their way repeating the error in every subsequent presentation until someone notices and corrects it.

Operational risk can be mitigated through process improvements, use of technology and better staff training. Regulatory risk can be reduced by improving operations and addressing deficiencies cited by regulators. But a tarnished reputation is extremely difficult to recover from; investment management firms rely on their reputations to succeed.

Automating the Last Mile

So, in the face of all these potential risks, what's an investment manager to do about automating that last mile? Best practices are to automate the entire process, from the first step to the last — regardless of the size of the firm. Automation helps reduce human error, creates operational efficiencies and includes built-in safeguards that eliminate the possibility of distributing material that has not been approved by compliance.

And speaking of compliance, Joanne K. Skerrett, an associate in the law offices of Sullivan & Worcester, LLP, urges CCOs of advisory firms to "[c]onsider how to implement new technology and regulatory requirements into the firm's policies and procedures" as one way to avoid winding up in the regulatory crosshairs. [4]

Getting started on automating the last mile has never been easier. There are lots of options. Firms can develop in-house software, purchase and install on-premises applications, or sign up for cloud-based services. Over the last decade, the cost of software has come down drastically and reliability has improved, so most firms should be able to find a solution that's right for them.

No matter which approach a firm takes, here are three key areas of functionality to look for:

1. **Quantitative data goes straight through from source systems to the final marketing materials and client reports.**

   Returns and holdings from the firm's accounting system, attribution and characteristics from analytics systems, and GIPS statistics, if applicable, should all flow straight through to the marketing presentations and other reports with zero manual updates. If a firm is massaging data because output from the source systems are incorrect, then the root cause for the data errors should be identified and fixed prior to automating marketing and client communications. If data needs to be scrubbed for any reason — for example, preferring to show names of portfolio holdings in Initial Caps instead of ALL CAPS — then automate that, too.

   Even calculating asset under management (AUM) by different criteria such as client type, geography and asset class can easily be automated. If accounts are coded by these values, then any marketing communications system will be able to produce the AUM numbers.

   > **Remember:** Every human touch point increases risks and should be eliminated.

2. **Checks for GIPS disclosures, mandatory slides and compliance approval.**

   Any automated last-mile solution should include safeguards against producing a presentation that does not include the most current GIPS CP slide and/or is not otherwise compliance-approved. Further, it is easy to miss a disclosure such as "Past performance may not be indicative of future results" on a page that was added at the last moment to address performance in a current market environment. A good automated system should have built-in checks for required regulatory elements and compliance approvals, with an alert or do-not-publish default if the presentation is missing vital pieces.

   While certain marketing materials such as product factsheets may seem short — typically 1-2 pages — they pack in a lot of information: composite returns, characteristics, overview of the investment philosophy, investment team information and description of the strategy are typical elements. It's easy to leave out updating disclosures such as the GIPS verification period when the process is not automated.

When it comes to marketing presentations, whether an introductory book discussing multiple strategies or a finals presentation focusing on a single strategy, it is common to have at least 15–20 slides in a deck. Each slide must be accurately numbered and contain all regulatory required content. A good automated system can manage this process. While it seems mundane, it is a vital step, since “supplemental material” disclosures within the presentation reference the GIPS CP slide that usually appears in the appendix. As marketing staff customize pitch books for specific presentations, old slides are removed and new ones added. It’s easy to end up with a disclosure referencing the CP with a wrong or nonexistent page number. This could constitute nondisclosure, so be sure any automated solution includes a solid page-numbering protocol.

> **Remember:** A good automated last-mile system should have built-in checks for required regulatory elements and compliance approvals, with an alert or do-not-publish default if the presentation is missing vital pieces.

3. **System provides a single pool of data and content for multiple communication purposes.**

Automated solutions can help investment management firms leverage the same pool of data and content beyond product fact sheets and marketing presentations, a feature that prevents discrepancies across different types of marketing and client materials. For example, investment managers who serve institutional asset owners must constantly update the various manager databases maintained by consultants with returns, holdings, AUM and attribution data, as well as use the same data for completing RFPs.

A robust software platform should allow a firm to automatically gather data from multiple systems, input insights from the investment team and have everything approved by various reviewers. A chief investment officer may need to approve a portfolio manager’s rationale for performance contributors and detractors to verify it is communicated in the context of the overall investment process. The director of research may want to approve analysts’ comments on sectors held in the portfolio. Personnel responsible for GIPS compliance may need to approve GIPS statistics.

Without a last-mile automated system in place, this critical information is typically provided through a combination of quasi-automated spreadsheets and manual content updates, leaving it prone to human error. A top-notch software system, however, becomes the single source for all the firm’s performance-related information regardless of output format. It helps pool data from various systems, combines this data with input from portfolio managers and then produces different types of materials, all while ensuring everything meets regulatory requirements. The output format shouldn’t matter.

> **Remember:** Input once, approve within the system, and only then publish it for use in various sales and marketing materials.

Trust but Verify

Automation can increase efficiency while reducing operational, regulatory and reputational risks. However, putting blind faith in technology is never a good idea. Software is only as good as its inputs. There is never a substitute for prudent checks and balances. There still must be controls to confirm automation is working accurately.

While software can produce materials in a few seconds, spot checking and verifying random samples to make sure all the t's are crossed and i's are dotted is a good practice. If not, to the extent that errors exist in automation, the same operational, regulatory and reputational risks apply. In fact, with automation, a wrong number can actually propagate much faster than with manual processes.

When deploying new software, it is recommended practice to run the new system in parallel with your existing process for a quarter and verify that output from both systems match. If there are mismatches, understand the root cause of the discrepancies and update accordingly. Be aware, however, that it is possible that the manual process produced erroneous data and the new system is actually accurate. Moving forward, each time there is a major software update, pay close attention to the output to verify everything is working as it should be.

When evaluating cloud-based offerings, it is important to do thorough due diligence on vendors' cybersecurity measures. According to a 2015 Investment Management Compliance Testing Survey, cybersecurity tops the list of compliance concerns for federally registered investment advisers — nearly 88% of respondents identified “cybersecurity/privacy/identity theft” as their No. 1 issue for 2015. And the SEC is right behind them. Speaking about key takeaways from the survey, Karen Barr, president and CEO of the Investment Adviser Association, says, “First and foremost is the heightened focus by advisers on addressing cybersecurity risks — an area identified by the SEC as a top priority as well.” [5]

Don't just focus on systematic defenses such as multiple layers of firewalls, but also consider sound security policies and hiring practices. For those considering building the software in-house or taking the install-on-premises route, be sure there is resident expertise to create, maintain and update a secure system that can stay ahead of new cyberthreats.

Technology can help bring the last mile up to par with the automation used in the rest of organization. However, investment managers can never delegate their duties to software. Firms will always need qualified compliance personnel and other professionals with the expertise to oversee processes and stay ahead of changing regulatory requirements.

Conclusion

No matter how vigilant an investment management firm is, mistakes can still slip into marketing materials and client reports, leaving the firm vulnerable to unwanted regulatory scrutiny. The key to reducing human error is automation coupled with controls, and most firms rely on automated solutions in their performance and attribution calculation processes. But the final and most important part of the process — pulling all the required information and disclosures into holistic marketing and client presentations — is still largely a mishmash of disparate manual and quasi-automated events.

Surely we, as an industry, can do better.

Automating this last mile removes human touch points from the equation to help produce accurate marketing and client materials and reduce operational, regulatory and reputational risks in the process. There are a variety of top-notch software solutions available to managers today that pool data from various systems, combine it with input from portfolio managers, and have built-in safeguards to prevent many common errors, all while ensuring the final marketing presentation meets regulatory requirements. In order to communicate consistently accurate investment results — and avoid regulatory attention — investment managers would be well-advised to automate the last mile when producing marketing presentations and client reports.

3 WAYS TO REDUCE RISK UNTIL YOU AUTOMATE THE LAST MILE

Automating the last mile of your client reporting and marketing presentation process is our recommended course of action. But if your firm isn't there yet, here are some steps you can take to help identify and correct manual errors in the meantime:

1. Use checklists.

Having a checklist of all the tasks that must be completed is a best practice for any manual process.

- Keep the checklist long enough to be meaningful, but short enough to be manageable.
- Have people sign and date the checklist.
- Keep checklist in a central location — not an email thread.
- Save the checklist with the materials produced.

2. Have a review process to identify and correct errors.

Without a fully automated process, peer review of materials for accuracy is one thing that can stand between your firm and the risks posed by errors. This review shouldn't be confused with — or be a substitute for — a compliance review. Rather, its sole purpose is to verify the accuracy of performance data and other information presented in the material.

- Identify a pool of qualified in-house reviewers to draw from.
- Select a reviewer who was not involved in producing the materials.
- Conduct reviews using data from the source systems, not intermediate spreadsheets.
- Have a robust process to communicate, correct and re-review errors.
- Re-reviews should encompass the entire data set in question, not just the "wrong number."

3. Standardize your marketing materials.

Standardized fact sheets, introductory books or finals presentations help cut down on errors. You still should use checklists and peer reviews, but if all material is standardized, these serve more as guardrails than road maps.

But standardized materials have a serious marketing and client service downside: They limit your ability to present information that speaks directly to the issues and concerns of your target audience. In an industry where every competitive edge matters, only you can determine whether the benefits of increased efficiency and error risk mitigation outweigh the potential loss of AUM.

About Richard Kerr of K&L Gates LLP

Richard Kerr is a partner in the firm's Boston office, where he is a member of the Investment Management, Hedge Funds and Alternative Investment practice group. Mr. Kerr focuses his practice on counseling financial institutions on corporate, regulatory, and transactional matters.

Mr. Kerr has experience advising investment companies, investment advisers, broker-dealers, banks, and other financial institutions on a broad range of corporate, regulatory, and transactional matters, including: formation and registration of investment companies, investment advisers and broker-dealers; reorganization transactions; mergers and acquisitions; public and private offerings of debt and equity securities; de novo bank chartering; holding company formations; and new product offerings. He has extensive experience representing financial institutions before federal and state securities and banking regulators, and self regulatory organizations (including FINRA and NSCC) in connection with such matters. In addition, Mr. Kerr has extensive experience advising financial institutions with respect to: development of their compliance programs; and marketing and advertising related matters.

Mr. Kerr also has significant boardroom experience, including representation of the independent directors of registered investment companies and the Boards of Directors of banking clients.

About Amy Jones, CIPM, of Guardian Performance Solutions LLC

Amy Jones, CIPM is the Founder and Principal at Guardian Performance Solutions LLC, a specialty compliance consulting firm dedicated to assisting investment advisory firms to implement, maintain and manage compliance with the Global Investment Performance Standards (GIPS®) as well as reviewing performance advertising materials for adherence with SEC requirements. She is a member of the United States Investment Performance Committee (USIPC), the CFA Institute's official local sponsoring organization for the GIPS standards in the United States. Mrs. Jones is a recipient of the Certificate in Investment Performance Measurement (CIPM), a credential awarded by CFA Institute that focuses on performance evaluation and the GIPS standards.

---

[1] "Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry." Mary Jo White, Chair. U.S. Securities & Exchange Commission. Speech delivered at The New York Times DealBook Opportunities for Tomorrow Conference. One World Trade Center, New York, N.Y. Dec. 11, 2014. http://www.sec.gov/News/Speech/Detail/Speech/1370543677722

[2] "An Investment Adviser's Fiduciary Duty." Lorna A. Schnase. August 1, 2010. http://www.thefiduciaryinstitute.org/wp-content/uploads/2013/02/lornaschnaseFiduciary-Duty-Paper.pdf

[3] "Amendments To Form ADV And Investment Advisers Act Rules." U.S. Securities & Exchange Commission. 17 CFR Parts 275 and 279; Release No. IA-4091; File No. S7-09-15; RIN 3235-AL75. May 20, 2015. http://www.sec.gov/rules/proposed/2015/ia-4091.pdf

[4] "Higher Standards on the Horizon for CCOs?" Joanne A. Skerrett. IAA Newsletter. Compliance Corner. Issue No. 271. July 1, 2015. http://www.sandw.com/assets/htmldocuments/1507_CompCorner.pdf

[5] "IAA Survey: Cybersecurity Continues to Top 'Hot' Compliance Concerns." IAA Newsletter. Issue No. 271. July 1, 2015. www.investmentadviser.org