INVESTMENT ADVISER ASSOCIATION

Avoiding Trade Errors: Best Practices and Learning from COVID-19

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Agenda

I. What is a trade error?

II. Who pays for a trade error?

III. The importance of prompt resolution.

IV. How to measure the costs of errors.

V. Mechanics of error correction.

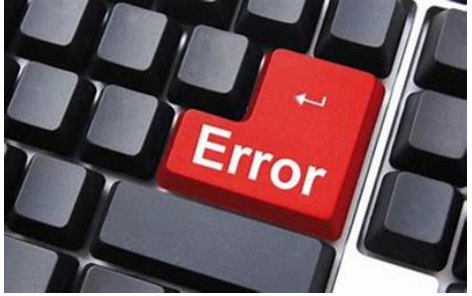
VI. Disclosure of error policies.

VII. Best policies and procedures.

What Is a Trade Error?

- SEC has never clearly defined scope of the term
- Is a bad investment decision an error? NO
- Types of trade errors:
  - Failure to properly execute an instruction of a portfolio manager;
- 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 position was placed but insufficient funds to cover purchase

What Is a Trade Error?
(continued)



- 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?
  - Relevance of the distinction between negligence and gross negligence – hedge clauses

Who Pays for a Trade Error?

- When is the broker or custodian liable?
- When is the adviser liable?
- When are employees liable?
- When is indemnification available?
- When is insurance available?

➢ **Practice Pointer:** Check your E&O coverage and deductible

- Can a client ever be forced to pay for an error?

The Importance of Prompt Resolution

- Costs potentially rise as time passes
- Errors do not disappear over time
- Concealment itself may be a breach of fiduciary duty
- Time value of money

➢ **Practice Pointer:** Perform daily trade reconciliation, timely notify custodian of trade errors, and timely report to insurance company

How to Measure the Costs of Errors

- Placing the client in the position it would have been in but for the error
- Measuring losses from errors
- Are lost opportunities part of the costs of errors?
- Is the time value of money part of the correction cost?
- How to treat the costs of processing the reimbursement of clients for errors, particularly where many clients are impacted
- When can profits from one error be netted against losses from another error?

Mechanics of Error Correction

- Principal and cross trade issues
- Use of an error correction account
- Reporting to clients on error correction
  - Contractual and legal obligations
  - Need for admission an error has occurred?

Disclosure of Error Policies

- Where does it belong?
  - Form ADV – Which section?
  - Other places for disclosures
- How much detail is needed?
- How should changes in the policies be provided to clients?
- Do clients need to consent to the policies?

➢ **Practice Pointer:** Make sure trade error disclosures align with how your custodian handles trade errors and that they are consistent with your policies and procedures.

Best Policies and Procedures

- Best practices for detecting errors
  - Reconciliation process
  - Employee attestations
- Best practices for correcting errors
- Best practices for disclosing errors
- Documentation of the process

Trading Practice Reminders for Volatile Markets

- Avoid using market orders when limit orders will do
- Pay close attention to order types and the intended time/means of execution
- Maintain controls and best practices for pre-market and after-market trading (not just regular trading), where errors can be magnified

Trading Practice Reminders for Volatile Markets (continued)

- Allocate block trades in a timely manner
- Make sure the client’s account has sufficient cash available
- Pay attention to any trade edits your custodian may provide
- Check the notional value of a trade prior to submission
- Pay close attention to option contract details

Hypothetical Discussion Questions

Hypothetical Fact Situation

Facts: Two years ago, a trade error occurred at an adviser to large institutions. $1.5 million in client losses were incurred to correct the trade error and an additional $1.5 million in client profits were missed because of the trade error. The chief compliance officer determined the trade error was caused by simple negligence, not gross negligence, and therefore did not notify clients of the losses and did not reimburse clients for the losses. Nonetheless, the trade error was noted on the adviser's error log and was briefly noted in the annual compliance review.

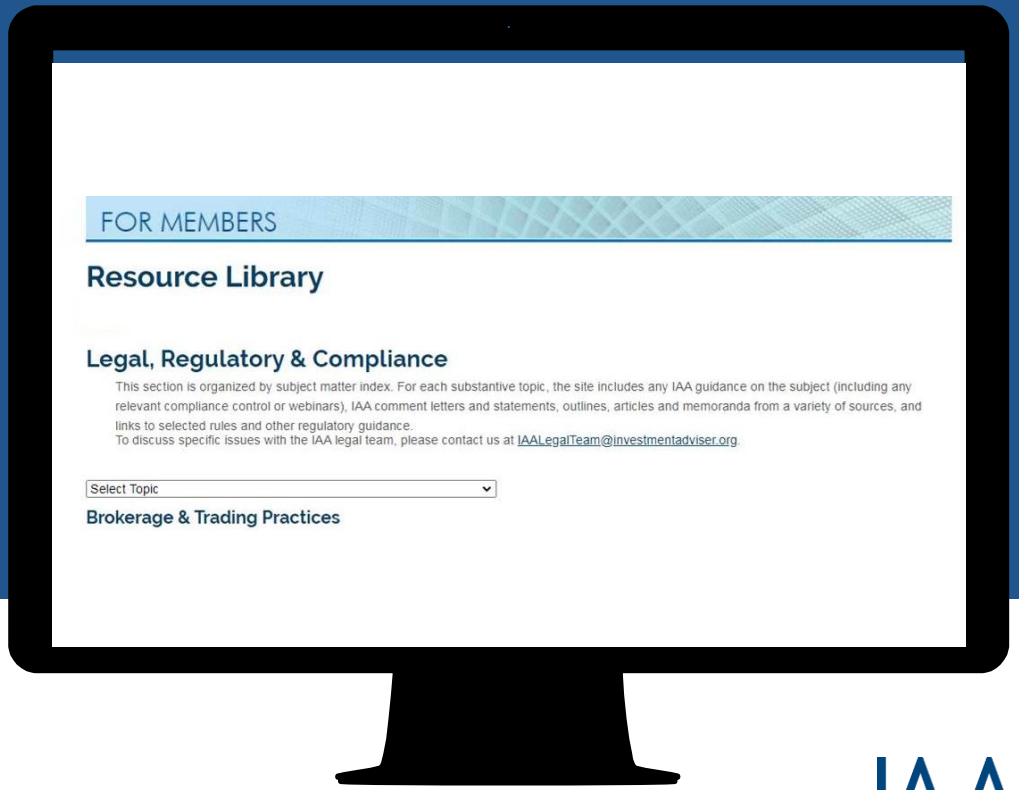
The SEC just sent the adviser notice of an upcoming inspection covering a period which includes the date when the error occurred. The SEC also requests the adviser's error logs and annual compliance reviews.

Hypothetical: Questions to Answer--Steps to Take

1. Was the compliance officer correct in the actions two years ago?
2. Should the compliance officer retain personal defense counsel?
3. Should the adviser hire outside counsel to investigate whether the error was caused by gross negligence?
4. Should the adviser make clients whole for the error now and, if so, how much should be paid?
5. Should the adviser notify clients now of the error?
6. Should the adviser notify the SEC inspection staff of the facts? If so, when? Should outside counsel make the communication?
7. Should the adviser notify the SEC enforcement staff of the facts? If so, when? Should outside counsel make the communication?

IAA Member Resources

- Resource page for IAA materials
- Contact the IAA Legal Team



Thank You

Any questions?

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