Confidence GAMES

After so many high-profile scandals, how can managers maintain clients' trust?

BY ED MCCARTHY

The initial meeting with the prospective client has gone well. Her approach to investment and wealth management corresponds with that of your firm, and her personality also seems to be a good fit. She asked intelligent, probing questions about your services and results, and you're confident that you've addressed her concerns. You ask if she has any additional questions. In response, she leans across the desk and asks, "How do I know you won't steal my money?"

While it might be tempting to lapse into a Richard Nixon impersonation and respond jokingly, "I am not a crook," a humorous response probably won't reassure investors in the post-Madoff era. That case and several other highly publicized alleged frauds have reminded investors that market fluctuations aren't the only source of risk to their portfolios. Strenuously asserting your innocence is also a risky response: Most of us have an unfavorable gut-level reaction to someone proclaiming his or her honesty and trustworthiness too loudly.

With a small number of dishonest advisers and managers dominating headlines lately, if your prospects and clients haven't brought up the topic of fraud yet, they probably will. Karen Barr, general counsel with the Investment Adviser Association (IAA), a Washington, DC-based industry group that represents the interests of U.S. SEC-registered investment adviser firms, reports that clients of IAA members are asking about fraud risk. "Our members are getting a lot of calls from their clients saying 'How do I know you really have my assets?'" says Barr. "And that's terrible. You have a relationship of trust with your clients, and all of a sudden they're reading the paper and questioning what's going on."

Although the fraud cases attract news coverage, in reality, very few investment advisers have business operations that resemble Madoff Investments. In a January 5, 2009, statement to a U.S. House of Representatives Committee on Financial Services hearing, the IAA noted, "According to April 2008 data from the SEC's Investment Adviser Registration Depository [IARD] system, only 5.8 percent of the more than 11,000 SEC-registered investment advisers are dually registered as broker/dealers and only 11 investment advisers—less than one-tenth of one percent—were like Madoff and received all their compensation as commissions. More than 95 percent of advisers charge asset-based fees, while only 9.3 percent of investment advisers charge commissions at all, much less exclusively. Unlike Madoff, the vast majority of investment advisers neither execute trades (themselves or through an affiliate) nor hold clients' funds."

That distinction might not suffice to reassure some clients; fortunately, however, you can take several steps to reassure clients that their funds are safe. These steps are generally straightforward to implement, and although they cannot provide clients with absolute assurance against fraud, they go a long way toward increasing comfort levels.

OPERATIONAL CONTROLS

The consultants and charterholders interviewed for this article agree that adequate operational controls are critical. Blaine Aikin, CFA, CEO of Fiduciary360 in Sewickley, Pennsylvania, cites three main areas: adequate checks and balances, ample third-party verification of key systems, and full disclosures. Under checks and balances, he believes the need for an independent custodian is a key element, an opinion echoed unanimously by other sources. Clear separation of roles—manager versus custodian, for example—within a firm is another important consideration, and full disclosure of the adviser's business relationships and any potential conflicts of interests is also vital. "There's no reason they [prospective investment clients] shouldn't ask every service provider working with them, 'Describe in full how you are paid. Tell me about your fees. Tell me about your affiliations. Do you in fact assume a fiduciary posture, or do you not? Do you have no intention of acting as a fiduciary? Do you have a conflict of interest policy? If so, let me see it.'"

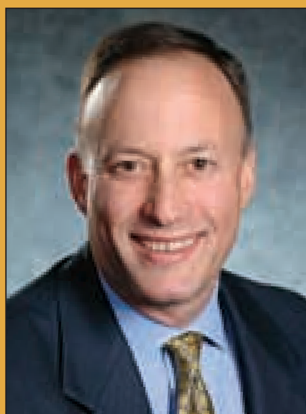
INDEPENDENT CUSTODIANS

With hindsight, the lack of an independent custodian should have been a red flag for Madoff's clients. According to Brian Hamburger, managing director of MarketCounsel LLC, a business and regulatory compliance consulting firm in Englewood, New Jersey, some larger firms act as both investment adviser and broker/dealer and "self-custody" clients' assets. In his experience, however, the vast majority of independent advisory firms utilize third-party, independent custodians. It's a practice Hamburger strongly recommends. "That in and of itself is perhaps the greatest control that we can have on the assets," he says. "Investment advisers need to be telling their clients, 'If you have any concerns as to the sanctity of your assets, contact the account custodian directly.' Often, investment advisers furnish their clients with the capabilities to do that through online access. In addition, account custodians are required to furnish reports on at least a quarterly basis. On top of that, investment advisers are usually offering and issuing quarterly reports that focus on the overall performance of the portfolio. So, clients are typically, in these types of scenarios, getting two reports from two different parties. They should pair up the reports and make sure that the assets on one are reflected on the others."

Hamburger believes that firms deciding to self-custody clients' assets should separate functions within the firm and retain independent third parties to monitor their activities. The IAA shares that opinion. In a 6 March 2009 letter to the Securities and Exchange Commission, Barr submitted several recommendations to reduce the risk of fraud in arrangements lacking an independent custodian to provide quarterly statements to clients. Those recommendations include, among others, internal controls that segregate custodial duties from advisory functions, involvement of independent third parties to provide evidence that clients' assets are safeguarded, and enhanced disclosures regarding the firm's self-custody arrangement and its risks.

"There are a number of practices that have been in place for years with entities such as banking entities that have lines of business that would best be independent from each other," says Barr. "They have protocols to segregate duties, so person A performs X function and person B performs Y function. We thought that would be a good analogy for this situation so firms can separate their custodial duties and personnel from their advisory functions and personnel, which would make it more difficult for fraud to be carried out."

Karen Barr



Stan Lee, CFA

Clients understand and value the role of an independent custodian, says Stanley Lee, CFA, senior vice president with the Greene Group, which is part of Neuberger Berman, LLC, in New York City. When the Madoff scandal first hit the news, Lee was speaking with a client with whom he has worked for 15 years. He was talking to her about the Madoff case, and although he had a long relationship with the client, he wasn't exactly sure how to assure her that it couldn't happen to her. "And she said, 'Wait a minute,'" recalls Lee. "'Your firm is independent. You manage money, and you have an independent custodian. I receive confirmations from the independent custodian, not from you. I receive statements from the independent custodian, not from you. I have online access to my accounts. I can see when checks go out [and] when money goes in, so from my perspective, it's totally different [from the Madoff case].' It was very refreshing to hear that."

Elizabeth Miller, CFA, president of Summit Place Financial Advisors LLC in Short Hills, New Jersey, also discusses the independent custodian's role in reassuring clients; Schwab Institutional currently serves as the custodian for Summit Place. Miller explains to clients that her firm is not a broker/dealer and that clients receive an independent confirmation of all trades from the custodian. "I tell them that although our relationship gives me a legal right to help manage their assets, they can sever that relationship at any time and always have access to their assets at the custodian," she says.

VERIFICATION

In some high-profile fraud cases, the financial auditing firms' failures have been highlighted. Those problems can be addressed by hiring an auditing firm that has sufficient resources for your firm's size and then making the audit findings available to clients. Janaya Moscony, CFA, president of SEC Compliance Consultants in Phoenixville, Pennsylvania, says it's also important that the auditor be genuinely independent. When her firm conducts compliance reviews of advisers and hedge funds, Moscony and her colleagues routinely check for any business or personal affiliations between the advisory firm and the auditor.

Third-party verification can extend beyond financial results: A firm's compliance under the Global Investment

Performance Standards (GIPS®) framework, and verification of that compliance, is another reassuring sign for clients, Aikin notes. (GIPS compliance and verification were not designed for fraud detection, however, as the alleged fraud at Westridge Capital Management illustrates.) Certification of a firm's fiduciary status is also gaining acceptance among advisers. The Center for Fiduciary Excellence (CEFEX), which is headquartered in Toronto, was started in 2006 by several standards development organizations. According to Carlos Panksep, CEFEX's general manager, the organization was established to perform the same function as certification bodies do in numerous other industries by using the International Organization for Standardization (ISO) system of standards. "We essentially observed, after talking with numerous experts in the retirement industry in the world of fiduciaries, that a system of certification and standard of fiduciary practice was not existent in this industry," says Panksep. "After a lot of discussion and review with experts and players in the field, we said, 'let's introduce something like this for fiduciaries.'"

Carlos Panksep

CEFEX certification is available in several categories for professionals and organizations: investment stewards, advisers, and managers; service providers; and fiduciary advisers. Applicants for certification must complete several steps, including an on-site assessment by an expert analyst. The analyst summarizes his or her findings and presents a report to the CEFEX registration panel. Panksep explains, "It's the independent panel that essentially agrees with the recommendation to certify or turns it down or issues new findings."

The average cost for the assessment is approximately $10,000; subsequent annual renewal assessments are required, and the renewal fee is typically 70 percent of the initial assessment. Panksep says that several firms have not passed the assessment, and in those cases, the registration panel can stop the process for nonconformity to the standards or issue a report called "An Opportunity for Improvement," which lists corrective measures.

Panksep says that interest in CEFEX certification is growing, particularly among firms managing less than $2 billion in assets. "That's probably the market that has jumped on this the quickest," he says. "[Certification] is a demonstration that a firm is proud and confident of its fiduciary practices. This is simply one message for a good firm to state that it follows the best practices in the industry and is confident enough to have a third party that's impartial and independent come in to perform an assessment to an open standard."

Background checks of a firm's principals and regulatory history are another method for reassuring investors. Aikin notes that a number of organizations exist that will perform these checks for roughly $500–$1,000, which is a fairly inexpensive way to identify problems lurking below the surface. "Anytime you do a background check, the person being checked has to give their approval to do that, and it's really not much different than hiring an employee," says Aikin. "You ask the person if they are willing to submit to a background check. If they are, they sign off on a form and the background check is done. In most of the major [fraud] cases that have come up, those simple background checks would have really set off some warning lights."

ADOPTING THE CODE

CFA Institute members agree to abide by the Code of Ethics and Standards of Professional Conduct and complete a professional conduct statement annually. The Code applies to individuals, however, not necessarily the firm, notes Jonathan Stokes, director for standards of practice at CFA Institute. In order to provide codes and standards that a firm could adopt, CFA Institute Centre for Financial Market Integrity developed the Asset Manager Code of Professional Conduct (AMC). The AMC's body of standards specifies the general responsibilities of managers in six broad categories: (1) loyalty to clients, (2) investment process and actions, (3) trading, (4) compliance and support, (5) performance reporting and valuation, and (6) disclosures. "We crafted it to give investment firms a model by which they can adopt their own code of ethics and standards and codes of conduct that are applicable to firm practices," says Stokes.

Section F of the AMC deals extensively with disclosures and how managers communicate with their clients. Specifically, the AMC states that managers should communicate with clients on an ongoing and timely basis; ensure that disclosures are prominent, truthful, accurate, and complete; include any material facts; and make a variety of specific disclosures (such as any conflicts of interest or regulatory actions taken against the manager, among other things). "Anytime you talk about trust," explains Stokes, "the first key ingredient of trust is communication, so the code has strong provisions

Blaine Aikin, CFA

related to communication and disclosure with clients."

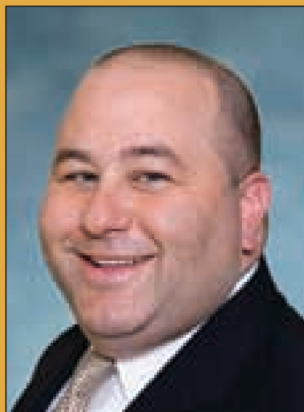
Currently, no verification provisions are in place to ensure that firms claiming to adhere to the AMC are in fact doing so. Nonetheless, Stokes believes that market forces eventually will lead in that direction, and he points to the history of GIPS as an example of how the AMC might evolve. Adoption of GIPS is voluntary, Stokes points out, but the market, particularly institutional clients, requires it. Stokes believes that similar market-based demand for AMC compliance will emerge and firms will need to adopt the code or risk not being considered by prospective clients. Growing acceptance of the AMC could lead to the emergence of third-party AMC verification services, similar to those that provide GIPS verification.

Although Stokes is optimistic about the AMC's adoption, he recognizes that codes of conduct don't deter fraudsters. "There's no code that's going to protect you from out-and-out fraud and deceit," he says. "But for those firms that are seeking to comply with best practices and function at the highest levels of ethics and professional conduct, the [Asset Manager] Code is a good way for them to show their clients that, 'We've adopted this. We're committed to this. These are the procedures and policies that our firm is going to follow. And here's the disclosure that we're going to give you, and here's our communication plan.' It is a good way of developing the trust and maintaining the integrity of the capital markets."

MARKETING IMPLICATIONS

Adopting controls and measures to prevent fraud offers a potential marketing benefit with prospects and clients, and it makes sense to demonstrate your "good guy" status when appropriate.

If your firm works with institutional investors, those organizations probably requested a due diligence request for proposal (RFP) before they hired you. Moscony suggests taking your responses to the RFP and putting them in a "frequently asked questions" format. An informative due diligence questionnaire is going to have all those questions that investors will ask, she notes, which makes it an ideal source of information. CEFEX certification and adoption of the AMC are actions that should be shared publicly as well. "We think a big benefit of having a code like the AMC is the ability to distinguish yourself from firms that don't have as rigorous a code of conduct or follow all aspects of the code of conduct," says Stokes. Aiken suggests providing investors the details on how you perform due diligence on outside managers and service providers. For example, if you use checklists to evaluate those firms, you can review the checklists with clients and prospects. "You're not going to be able to guarantee or profess to have some clarity around where the markets are going," he says, "but you could certainly say with great certainty, 'Here is what I do. Here is how I manage money. Here is how I do my due diligence. Here is how I check disclosures.'"



Brian Hamburger

Going beyond the required regulatory disclosures, however, involves a balancing act: You want to provide evidence of your integrity without raising suspicions as to why you are emphasizing that integrity. When someone tells us we can trust him, for instance, we often wonder why that assurance is needed. There is an additional potential problem in this area, Hamburger cautions. He agrees that firms that can demonstrate their regulatory compliance and the safety of clients' assets will have a competitive advantage over firms that can't or don't make similar claims. But those claims are a double-edged sword: "Any statements that an investment adviser makes to indicate that they are going above and beyond minimal compliance requirements really is serving to raise the bar in terms of what their obligations are because an investment adviser cannot make statements that are misleading," he says. For example, if an adviser claims to monitor accounts and reconcile those accounts with the account custodian daily, explains Hamburger, that's the standard to which the regulators will hold the firm.

SEEKING TRANSPARENCY

"Transparency" is an overused buzzword, but increasing transparency is the common goal of the methods described in this article. If clients understand how you are managing their funds and can verify their accounts' transactions and positions with a reliable, independent third party, many of their potential concerns will be allayed. Achieving that result doesn't have to be a complicated or expensive procedure: A clearly explained investment process, an independent custodian, a straightforward fee structure, and an avoidance of assets that are difficult to price and monitor can satisfy clients. This is the approach that Eads & Heald Investment Counsel in Atlanta, Georgia, takes, according to Matthew Eads, CFA, a portfolio manager at Eads & Heald. "Our only fee structure is a percent of assets under management," says Eads. "There are no hidden fees; there are no commissions. We don't have any off-the-shelf proprietary products. Everything we put into a client's portfolio is a high-quality exchange-traded asset—in our particular case, individual stocks and bonds."

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