Risk Focused: Third-Party Reviews as Part of an Effective Risk Management Program

Marina Baranovsky, Scitus Consulting LLC, and Jennifer Zordani, Zordani Law, P.C.*

The SEC's Focus on Risk

The SEC's Division of Investment Management has recently focused on investment advisers' identification and oversight of a wide variety of risks that pervade their businesses. Aside from inherent investment risk, advisers are tasked with paying explicit attention to risks arising from violations of applicable laws and regulations, conflicts of interest, breaches of contract, failures to act in accordance with the firm's own policies, cybersecurity, risks relating to the firm's client relations, business competition, and reputation, among many others.

A series of SEC regulatory initiatives stemming from the financial crisis – adopted enhanced data reporting requirements and liquidity risk management for open-end funds, a proposal on derivatives, and an anticipated proposal on stress testing for large advisers – are intended to further reform different aspects of risk management.

Other SEC divisions and offices have become more adept at risk management as well. The Division of Economic and Risk Analysis (DERA) has developed tools to proactively detect anomalous results in data and identify aberrational performance and other factors that indicate fraud or other serious malfeasance at the advisory or fund level. Meanwhile, the Center for Risk and Quantitative Analytics (CRQA) coordinates risk identification, risk assessment and data analytic activities. Unsurprisingly, SEC staff is also making use of data submitted by its registrants, publicly available data and industry-related measures. These efforts – to enhance risk identification, assessment and analysis – ultimately inform the actions taken by the Office of Compliance Inspections and Examinations (OCIE).

Marina Baranovsky, Principal, Scitus Consulting

Jennifer Zordani, Principal, Zordani Law, P.C.

The SEC's Recognition That Regulation Might Not Be Enough

Consistent with its focus on risk and its enhancement of its internal analytics, the SEC staff recognizes that OCIE may leave stones unturned. Although OCIE has increased its staffing in response to a perceived need to increase the frequency of investment adviser examinations, the SEC is actively considering proposing mandated third-party reviews in connection with compliance examinations of investment advisers. Despite the SEC's efforts to reallocate some of its resources, OCIE and the SEC Division of Enforcement continue to face a herculean task. A mandated third-party review proposal would be an explicit request for the industry to assist with that task.

Many difficult issues would need to be considered and addressed before any potential third-party involvement could be implemented. However, it is worth considering ways that advisers can increase their focus on risk and benefit from voluntary third-party reviews.

Following the SEC's Lead: How Advisers Can Increase Their Focus on Risk

Taking their cue from the SEC's recent actions, advisory firms could also enhance their risk identification, assessment and analysis, such as by having formal risk management programs. **Risk reviews** often are driven by compliance, and typically include the

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full range of subjects that compliance is required to address, whereas **risk management programs** are broader and deeper in many respects.

Consider the example of an adviser that transacts in Level 3 Assets which, by virtue of being very illiquid and hard to value, rank high on risk rating scales prepared by compliance. The adviser evaluates at the outset whether these assets are approved for a particular investor or fund, and confirms that appropriate disclosures are provided. The adviser has an established process for legal and compliance reviews of these transactions. It also has a process to monitor market and other financial risks. And specific personnel have defined roles and responsibilities for these activities, which are documented.

An effective **compliance program** addresses the procedures for transacting in Level 3 Assets but are relatively basic – and no different than procedures that many advisers use for other types of assets. A **risk management program**, however, considers more than what would be required by the SEC's compliance program requirements alone. A risk management program will consistently:

- View risk management as an entity-wide endeavor;
- Utilize expertise from key personnel outside of compliance and legal, including operations and management;
- Evaluate what data and information is available;
- Make an assessment as to whether to utilize the available data and information for risk reviews;
- Regularly monitor underlying assumptions and criteria;
- Require multiple areas of the firm to contribute information and analysis specifically directed at reducing firm risks and risks to clients, including identifying anomalies;
- Demand prompt reviews and responses by the appropriate personnel; and
- Provide reporting of significant events to senior management.

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A risk management program reviews the full spectrum of financial risks, reviewing not just default risk, but other aspects of credit usage, leverage and liquidity. For instance, there is an obvious correlation between Level 3 Assets and the probability of default risk, but tolerance levels differ by firm (and within a firm). Insight from a range of operational, financial and management personnel as to why they recommend certain tolerance levels will lead to better-informed risk reviews and facilitate updates more quickly when changes to the underlying assumptions occur.

In considering what data and information is available, an adviser should also consider what comparisons might identify anomalies. With Level 3 Assets, it might assess changes in those assets relative to other assets within the firm. In other situations, changes relative to a parent or holding company might be relevant and useful. In addition, comparisons to peers and competitors are useful for a variety of reasons, including because the SEC is making these types of comparisons. Of course, there are inherent limitations where information is not publicly available.

If an adviser places singular or heavy reliance on annual assessments from compliance, that is an indication that there is not an enterprise-wide commitment to risk management or a fulsome risk management program. Larger firms with risk committees and Chief Risk Officers are familiar with a multi-department and multi-dimensional approach to risk and implementing risk management programs. But firms of all sizes should be tailoring risk management programs to their activities.

How Third-Party Reviews can Increase the Effectiveness of an Adviser's Risk Management Program

While the debate over SEC-mandated third-party reviews continues, a significant segment of the advisory industry currently benefits from voluntary third-party reviews as a way to strengthen their programs. These advisers use service providers for basic reviews (*e.g.,* compliance checklists), customized reviews (*e.g.,* responding to investor requests) and targeted reviews (*e.g.,* providing directors and senior management with detailed information on particular topics). Regardless of the impetus behind a third-party review, recent risk-related regulations, coupled with the SEC's expanded risk analytics, strongly suggests that advisers are going to be asking their third-party reviewers to spend more time looking beyond the compliance department as they provide risk-related assessments.

On the other hand, advisers that struggle to address compliance requirements in an effective manner may not initially benefit from a risk review, since a third-party reviewer's priority will be basic compliance requirements. Consider, for example, advisers that engage sub-advisers without having or conducting appropriate evaluation and monitoring procedures. These firms are unlikely to be evaluating risk sufficiently if there is a huge information gap in an area of the firm that is integral to the adviser's business. For firms that have basic compliance issues to address, requesting a third party to conduct a risk review is putting the cart before the horse.

This leaves the great majority of

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advisers that can benefit from third-party reviews that focus on the risk. These enhanced forms of review can be paired with a compliance review or conducted separately to target particular aspects of the firm's activities (rules, processes, departments or products). The approaches taken by third-party reviewers will vary as they correspond to the firm's size, business, resources, and, importantly, dedication to compliance and risk management. Regardless of the approach, advisers that utilize voluntary third-party reviews that increase their focus on risk will be better positioned regardless of whether the SEC moves forward with another level of regulation.

**Jennifer Zordani is the principal of Zordani Law, P.C. based in Chicago, IL. She counsels investment advisers, broker-dealers and professional traders on regulatory, transactional and litigation matters. She can be reached at (312) 380-6555 or* jzordani@zordanilaw.com.

Marina Baranovsky is the principal at Scitus Consulting based in Washington, DC. Her services and expertise are focused on Risk Assessment for Registered Investment Advisers and Broker-Dealers. She can be reached at (703) 688-2534 or mbaranovsky@scitusconsulting.com.

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