



Risk Management Update September 2008

Fund Managers Should Actively Review Disclosures and Portfolio Mandates

On July 30, 2008, the SEC issued a public administrative order and cease and desist proceedings against the Pax World Management Corp. ("Pax"). In this order, the SEC charged Pax with violating investment mandates of its funds (SEC Administrative Proceeding IA-2731). Pax utilized a socially responsible investing ("SRI") model, which excludes companies from the Pax funds based upon certain business practices (revenue derived from weapons, nuclear energy, alcohol, tobacco, etc.). The SEC found that from 2001 through early 2006 Pax held at least one company in one of its funds that should have failed Pax's SRI screens and restrictions.

This administrative order highlights the need for funds, advisers and other investment professionals to conduct transactions in accordance with investment guidelines. Specifically, technology solutions, such as pre-trade surveillance systems, should be implemented to ensure that industry professionals invest client monies and perform portfolio management in accordance with stated investment mandates and restrictions. In addition, advisers must continuously take into consideration all client disclosure documents, including Forms ADV, Contracts and Offering Memorandums to ensure that those materials reflect current investment practices.

One method for preventing investment guideline violations is to implement continuous monitoring processes and supervisory oversight. This review should encompass portfolio management and trading activities and the compliance policies and procedures which governs them.

Portfolio Management Review Process

Investment professionals engaged in portfolio management should implement and adhere to a defined investment review process involving two steps - transactional reviews and periodic reviews.

A transactional review occurs contemporaneously with each transaction. A pre-trade review would trigger a "red" flag which would alert the trader that the transaction, if placed, would be violating an investment guideline or restriction based on holdings, relative size limits of each position, directed brokerage, and other portfolio criteria. A post-trade review is similar, but occurs after the transaction is made. While effective, post-trade surveillance, if not timely followed, could result in expensive trade corrections.

A periodic review helps to ensure that the portfolio is managed in concert with investment mandates and client directives. It also helps identify trends which may signify deviance from stated portfolio objectives for style, relative risk, position weightings, allocation models, and capitalization portfolio concerns. As an added measure of risk mitigation, consider forming a risk management committee to conduct this review.

Investment firms should develop adequate procedures in the event a non-compliant security is found in a portfolio. Such procedures should address the time frame, tax consequences and impact on the portfolio of the timely removal of the non-compliant portfolio holding.

Policies and Procedures Review Process

All portfolio review processes should be clearly defined within the firm's policies & procedure manual. The firm should continuously review policies and procedures to ensure that they:

- Remain relevant to the firm's business;
- Reasonably capture data needed to survey activity; and
- Address process dealing with detected violations .

Lastly, all portfolio management and compliance personnel should have a working knowledge of the rules that govern portfolio management and the regulatory obligations related to this activity. Those obligations include the duty to invest in accordance with stated objectives and conduct all operations in a manner that is honest, fair and ethical.

Please contact our offices for additional guidance on implementing a comprehensive review of your portfolio management practices.

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