

PRACTICE MANAGEMENT

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Operational Risk Assessment

THE FACE OF THE REGULATORY AUDIT HAS changed. Historically, examiners focused much of their attention on required books and records. The new SEC audit is a risk-based audit that subjects the adviser to inquiries about the adviser's risk assessment documentation, including its inventory of compliance risks, minutes from risk committee meetings, and standard operating procedures for risk identification and assessment. Due to the fact that no two advisers are alike, each will have its own distinct areas of exposure that are tied directly to its operations and activities. In identifying these areas, the adviser is in a unique position to evaluate its internal controls and sharpen its business practices. To that end, the risk identification and assessment process should be viewed not solely as a way to merely survive a regulatory audit, but also as a way to shield an adviser from the expense that ensues from regulatory citations or unnecessary litigation.

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From the President



John McClure

AS SUMMER TURNS TO FALL, our children return to school and we to work, I thought it appropriate to outline some of the important tasks and tremendous opportunities NAAIM has to look forward to in the coming months.

Coming off a very successful annual conference and with several marketing initiatives in the works to increase membership and raise awareness of the Association, now is a great time to get involved. In case you're not aware, NAAIM is an all-volunteer organization. So, if you haven't already been asked, show your support and join a committee.

Following is a list of committees, their activities, and contact information for the respective chairpersons:

Membership Marketing

Chair – Will Hepburn

Contact: will@hepburn.com

Description: The primary goal of the committee is to promote and further expand the membership of NAAIM.

Activities:

- ❖ NAAIM WIKI – A collaborative, password protected section of the NAAIM web site currently under development where members can submit ideas, thought leadership, articles, etc. to promote active money management.
- ❖ Guide to Active Management – Currently revising the guide on the NAAIM web site. Seeking active money management strategies from membership to help promote the Association.
- ❖ NAAIM that Trend Index – Currently there are 40 members participating in the index. Keep an eye out for weekly emails from Will and respond accordingly.
- ❖ NAAIM Spotlight on Members – Looking for members with proven trading strategies to spotlight in The Active Manager.

Agenda Committee

Chair – Victor Vuskalns

Contact: victor@tangollc.com

Description: Plans *Uncommon Knowledge*, NAAIM's annual conference including speakers, agenda, sponsor opportunities, and all social events.

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Operational Risk Assessment

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The adviser must begin with an introspection of its services and relationships. At a minimum, this internal analysis should consider portfolio management, trading practices, personal securities transactions, accuracy of disclosures, safeguarding of client non-public personal information, books and records retention, marketing, valuation of fees and client holdings, and business continuity planning. In any given area the adviser must first identify the risks associated with that area given its specific operations. Next, the firm should assess its susceptibility to being exposed to the identified risk. Finally, the firm should consider establishing additional internal controls to mitigate its exposure to that risk and reduce its level of susceptibility.

Portfolio management covers the entire scope of activities within which the firm engages in servicing accounts, from the process by which an adviser determines its clients' suitability and investment objectives to every stage of the daily management of its clients' portfolio. Connected to managing a client's account is an adviser's *trading practices* and the adviser should focus on all elements of its relationship with the current broker-dealer and account custodian. A necessary risk implicit with executing client transactions is that the adviser and its employees have access to client information. Policies on *personal securities trading*, commonly included within an adviser's Code of Ethics, seek to establish guidelines for employee and firm trading, and the adviser should analyze the extent to which its trading practices are satisfactory taking into consideration its risk exposure in light of its fiduciary and legal responsibilities.

From a disclosure standpoint, the adviser should review the *accuracy of its current disclosures*, not only with respect to its policies on personal securities transactions, but also to its conflicts of interest disclosures found in its Form ADV to ascertain their sufficiency in mitigating the risks present in the firm. When a client discloses information to the adviser, that information must be protected from unauthorized parties. The then-current protections that are intended to *safeguard client non-public personal information* may not be enough for certain firms that have numerous relationships and affiliations. The more affiliations a firm has, the greater the potential there is for the firm to lose control over the flow of information. By no means is this the sole manner of exposure with respect to safeguards in this area, but the firm needs to assess whether its internal controls should be amended, or supplemented.

If an adviser has difficulty in ascertaining additional areas in which it should focus its inquiry, the adviser need not look any further than an examination deficiency letter. Frequent comments center on internal controls in the areas of *books and*

records retention, marketing and valuation of fees and securities. Firms should analyze all angles of their record keeping, marketing activities and valuation of fees and securities, and from this analysis review their controls to prevent exposure or regulatory liability.

There are operational areas that may not focus on the client-adviser relationship, but have an indirect impact on the client, and the firm's ability to service the client. For example, investment advisers are required to establish and implement a *business continuity plan*, the purpose of which is to set forth a framework for continuing its operations through a disaster or emergency situation. Similar to the Form ADV, as an adviser evolves so must the details of the business continuity plan.

From an analysis similar to that prepared above, the firm must consider adopting additional policies and procedures that are intended to reduce the risk presented from a compliance standpoint. The firm's risk identification and assessment must evidence a consideration of those compliance areas that are relevant given the firm's operations, and the scope should be narrowly tailored to only those areas relevant to the firm. In so doing, the product of this introspective analysis can be used to target organizational issues and weak internal controls that can lead to regulatory or client-related problems.

As with all regulatory requirements, it is extremely important for the readers to consult with the Advisers Act directly and/or obtain counsel competent in this area for the full breadth of requirements and expectations. The investment advisory atmosphere has become exceedingly litigious, and it is absolutely imperative that investment advisers understand and satisfy their regulatory and fiduciary obligations

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