Seven Rules of Thumb for Post-Trade Compliance
What Fund Administrators Need to Know

A growing body of regulations governing investment portfolio management has expanded both the scope and frequency of portfolio compliance testing. This paper is intended to provide fund administrators with guidelines for implementing an effective post-trade compliance program that will meet the increased demand for more frequent testing, scalability and control.

Executive Summary

For fund administrators (Administrators), the burden of understanding and satisfying compliance with investment limit restrictions has grown rapidly over the past five years. Consequently as the need for daily testing becomes the norm, conventional manual methods of tracking, testing and reporting trade exceptions have become unmanageable at best.

Even with the best technology available, managing post-trade compliance requires Administrators to observe a series of seven operating principles, or rules of thumb.

1. Understand Your Responsibility
2. Automation Is Critical
3. Assure Data Integrity: Garbage In, Garbage Out
4. Daily Monitoring Is Key
5. Declare Independence
6. Agility Counts When Changing Rules
7. Control And Audit: Automating Checks And Balances Is Crucial

Background

During the bubble economy of the late ’90s and beyond, the perception that mutual fund practices were not as fair, safe or honest as the industry previously represented them became widespread among investors.

A series of highly publicized mutual fund scandals in the early ’00s, involving late trading and market timing, did little to alleviate fears. The result was decreased investor confidence and increased federal oversight and enforcement, which in turn meant significant changes in the regulatory approach to audits and examinations.

Pre-Trade vs. Post-Trade Compliance Testing

Pre-Trade.

Pre-trade testing is performed by the investment adviser (Adviser) before a trade is placed and on the trade date. For smaller funds with limited trading activity, pre-trade testing may be done manually, but is typically associated with automated trade order management systems that include testing for a fund’s compliance with investment limits.

Post-Trade.

Post-trade testing is typically performed by the fund’s Administrator, an entity independent of the Adviser. This testing uses accounting system data to test a fund’s compliance with investment limits daily during overnight batch processing and uses the prior day’s actual values, not estimates. This testing involves either manual or automated processes.

These Rules require each fund and registered investment adviser to adopt written compliance policies and procedures reasonably designed to prevent violation of federal securities laws, review the adequacy of those procedures annually and designate a chief compliance officer (CCO) responsible for their administration. The CCO is empowered with full responsibility and authority to develop and enforce appropriate policies and procedures to achieve the compliance objectives. On an ongoing basis, the CCO is accountable for keeping the board apprised of significant compliance events and advising the board of needed changes in the compliance program.

One component of the compliance program is the Administrator's oversight of funds and fund adviser's trading activities which has increased to include verification that the selection of securities complies with regulations, fund disclosure requirements, best practices and the fund’s own investment policies, such as investment limit restrictions. The portfolio manager and trader initially complete this verification before the trade is placed and on the date of the trade. However a second verification is typically completed by the Administrator on the trade date +1.

The scandals and subsequent regulations result in mutual funds today being among the nation's most heavily regulated industries leading fund companies and advisers to continue to strengthen their compliance efforts.

What is post-trade compliance and why is it important?

Post-trade compliance is the monitoring of changes in a fund’s portfolio due to investment decisions made by the Adviser against pre-established investment restrictions. The goal is to identify actual and potential violations that could result in harm to the shareholder. While some non-compliant situations may result from intentional trading abuse, the majority are due to changes in the market value of securities, data discrepancies or misinterpretation of investment limit restrictions.

The following types of investment limit restrictions may be tested.

**Diversification limits** measure asset exposure to issuers.

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**Examples of Post-Trade Compliance Testing Exceptions**

**Trading errors.** When a trade placed by the Adviser is in violation of investment limits, the Adviser must take corrective actions as quickly as possible to minimize harm to the shareholder.

**Interpretation and creation of restrictions.** Testing identifies discrepancies with the interpretation and creation of restrictions between the Adviser and Administrator.

**Failure to meet the fund’s objectives and strategies.** Testing identifies exceptions that are not in compliance with the fund’s investment objectives and principal strategies.

**Potential disclosure issues.** An exception may result in a more detailed review of disclosure documents.

**Use of estimated portfolio values.** Pre-trade compliance testing uses final asset values from the previous trading day, which are estimates for the current day’s trading activity.

Post-trade compliance testing uses actual portfolio values and highlights data exceptions not identified during the pre-trade compliance testing process.
**Concentration limits** measure asset exposure to industries.

**Security limits** measure asset exposure to security types, such as bonds.

**Income limits** measure exposure to classifications of revenue.

While pre-trade compliance testing is important to prevent potential compliance rule exceptions prior to the execution of the trade, it is important to note that a portfolio compliance testing program is not complete without a post-trade compliance testing program.

### The Seven Rules Of Thumb for Post-Trade Compliance

#### 1. Understand Your Responsibility

Administrators are frequently contractually obligated to oversee, monitor and test the trading activities of the Adviser to ensure funds are in compliance with investment limit restrictions.

To identify violations in a timely manner, the Administrator must test and analyze exceptions on a daily basis. If violations occur, the Administrator must escalate the violations to the CCO and senior fund managers as quickly as possible to facilitate resolution.

The Administrator is also responsible for retaining testing records and for reporting findings to the fund’s CCO and the board of directors, as required.

#### 2. Automation Is Critical

Manual processes lack controls and can compromise data integrity, impede proper compliance test performance and may result in costly errors. This, coupled with the growing demand for timely and accurate daily testing, is driving the need for automation. Without substantial additions to staff, using manual processes for daily monitoring has been nearly impossible due to the time-consuming nature of the task. Even then, manual testing is at high risk for error.

When Rule 38a-1 was first adopted, firms focused on developing their compliance programs, evaluating their compliance monitoring controls and documenting their associated policies and procedures. At that time, many Administrators relied on manual processes that were generally performed monthly or even quarterly, due to time and resource constraints.

Compliance testing requires the interpretation of legal terms, the identification of obscure data sources and the checking of intricate portfolio and general ledger data. Manual methods of testing require the Administrator to identify non-conforming data and test exceptions by comparing multiple reports and spreadsheets against lists of restrictions.
These manual methods are time-consuming, error-prone, lack process controls and are not flexible or scalable enough to support daily testing. Because they lack process controls, manual methods are generally not favored by auditors or regulators.

To establish compliance testing programs in a repeatable, scalable and cost-effective manner, firms are automating their processes and introducing standard controls. Automated compliance systems can provide important benefits to Administrators. Such systems can:

- **reduce costs** by ensuring timely identification of compliance violations by streamlining and consolidating systems for data management and compliance testing;
- **eliminate risk** by performing more frequent testing to eliminate the risk of violations going undetected for extended periods of time;
- **elevate service levels** by meeting the demands of management, the CCO and the board of directors for flexible, accurate and timely reporting, and by ensuring violations are addressed and resolved quickly; and
- **increase scalability** by establishing daily, comprehensive testing without increasing staff and gain the flexibility to readily adjust to business and regulatory change.

Administrators should evaluate and select an automated solution that best meets the business needs for their post-trade compliance testing program.

### 3. Assure Data Integrity: Garbage In, Garbage Out

Effective testing requires that funds collect, create, confirm and deliver data with appropriate controls in place. But good data is required to get good test results. Multiple data sources, missing data and data that have not been validated, all contribute to eroding confidence in test results.

One key to safeguarding the integrity of data is to centralize it so that every user in every job function relies on the same set of data. Using a single system to manage and test data resolves conflicting approaches to validating and preparing data for analysis. The result is consistent data integrity throughout the organization.
Collect. Firms must first identify which restrictions are to be tested and the data required for testing. They must then identify the sources for the appropriate data. Multiple data sources are generally required, including the fund accounting system and other third-party data sources.

Create. Administrators must create data validation rules to confirm the integrity of data, including whether its data set is complete and accurate.

Confirm. Administrators identify, research and resolve data exceptions. Once data is validated, compliance tests can be performed.

Deliver. Administrators deliver valid test results.

Administrators resolve “garbage in, garbage out” data integrity issues by automating the data management process.

4. Daily Monitoring Is Key

CCOs and boards of directors are requiring more frequent – usually daily – comprehensive testing to identify problems and to quickly resolve issues. Timely information reduces the potential cost of correcting shareholder losses as a result of a violation. The longer it takes to identify and correct a violation, the greater the risk that market movement can cause that loss to grow exponentially.

The manual methods used by some Administrators will not support daily testing. And the steadily growing volume of trades, together with the increasing complexity of compliance regulations, only exacerbates the problem. In order to satisfy the need for daily compliance monitoring and testing, Administrators are adopting automated tools that can monitor trades and test compliance against applicable investment limit restrictions.

Daily testing enables the Administrator to be proactive, identifying and reporting potential compliance issues before they occur. By establishing warning thresholds and addressing non-compliant situations, Administrators can escalate potential problems. Fund CCOs, board members and regulators expect issues to be identified in a timely manner and promptly resolved to minimize impact to shareholders.

5. Declare Independence

Some fund companies with in-house advisory and administration functions use the same system for trade order management and for portfolio compliance monitoring and testing. However there is a strong case for using a separate, independent system to verify the results of the trading activities of the Adviser.

Independent post-trade compliance testing acts as a safety net to capture exceptions not identified during the pre-trade compliance check that could remain undiscovered indefinitely. Independent testing helps to avoid potential conflicts of interest by offering complete independent oversight. It also helps to identify discrepancies with the interpretation and creation of restrictions between the Adviser and the Administrator.

6. Agility Counts When Changing Rules

Some compliance rules are mandatory, some are voluntary and others are market-driven. But none are absolute or timeless. An annual review of each fund’s prospectus could easily lead to rule changes that need to be reflected in the post-trade compliance system. As new investment products are created, new rules are adopted and new fund management
procedures emerge, the restrictions which govern investment practices must evolve with them.

To prepare for post-trade compliance testing, Administrators must:

- review regulatory restrictions, fund disclosure documents and best practice rules to identify specific investment limit restrictions that require testing;
- interpret restrictions and define the formulae and metrics to be used;
- identify the portfolios to be tested and determine the frequency of testing;
- establish a notification protocol in the event of any violations; and
- monitor any new or changed restrictions.

When rules change, Administrators need the agility to respond quickly. They must have the flexibility to change defined rules regardless of the system they are using to support their post-trade compliance processes. Updates should not depend on programmer intervention or lengthy system update cycles. Rule changes in the system should account for the appropriate management approvals and audit trails. Automated solutions should provide access to a pre-built standard rules library to avoid inconsistent legal interpretation and to notify users of updates to these rules.

7. Control And Audit: Automating Checks And Balances Is Crucial

A fund must have proper controls in place to demonstrate that:

- appropriate tests were carried out and exceptions identified;
- exceptions were analyzed to identify violations;
- appropriate remedial actions were taken;
- stakeholders were issued the proper notifications;
- tests were properly documented;
- proper permission controls were in place regarding system set-up and maintenance; and
• proper checks and balances existed between the Adviser and Administrator.

Automating post-trade compliance allows firms to respond quickly to information requests from auditors and regulators. It provides a complete audit trail that can be quickly extracted from the system instead of having to go through the lengthy and tedious process of pulling hardcopy documents from paper files and compiling them for examination.

**Conclusion**

This paper provides Administrators with guidelines for implementing an effective post-trade compliance program that will meet the increased demand for more frequent testing, scalability and control.

Automating a fund’s post-trade compliance testing process improves service levels through more frequent monitoring. It provides flexible, accurate and timely reporting to meet the needs of management, the CCO and the board of directors.

Automated systems that leverage one centralized platform provide Administrators the ability to collect and validate data, create restrictions, highlight test exceptions, provide historical and analytical data to assist with resolving exceptions, deliver notification and exception reports, and provide process controls. Automated systems should also be easy for business users to deploy, use and manage.

The prevailing trend for Administrators is to consolidate all of their back-office needs onto one platform and to centralize and leverage data for multiple regulatory, reporting and compliance requirements.

**About the Author**

Lynn Majetich joined Confluence in 2006 as a Product Manager in the Product Management group where her primary focus is regulatory compliance. Prior to joining Confluence, Lynn worked at Federated Investors for 15 years in various capacities, including AVP Compliance Manager, AVP of Client Services & Product Management and Principal of broker/dealer operations. She attended Slippery Rock University and earned her BS degree in Education. Lynn attained NASD Series 6, 26 and 63 licenses and is Pragmatic Marketing Certified (PMC). She is currently working on a certification for New Product Development Professional (NPDP).
About Confluence

Confluence is the global investment management industry’s leading provider of automated data management solutions. Unity™ from Confluence, a comprehensive fund administration platform designed to enable investment management firms to reduce costs and eliminate risk through automation and consolidation of critical business processes, has emerged as the administrative hub for asset managers.

Leveraging one centralized database, Unity replaces multiple time-consuming, costly and error-prone manual processes with the ability to achieve mass customization, process consolidation, and complete automation of vital reporting functions. With 11 product solutions that can stand alone or work together to leverage the power of a central platform database, Unity verifies data once, stores it, and reuses it for multiple purposes. Additional financial reporting and expense management products are available as bundle packages to provide greater benefits and more efficient pricing options. For additional information about Confluence products and services, please contact info@confluence.com.

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