Addressing Compliance Risk: Three Birds, One Stone

EXECUTIVE SUMMARY[1]

Legal and regulatory risk is anywhere and everywhere these days. Specifically, suitability risk can be very important for advisers, particularly those with portfolio construction processes that are less well defined. Why are clients with very different financial circumstances in the same portfolio? Why are clients with very similar financial circumstances in different portfolios? How did the adviser determine and monitor the client asset allocations? A clear process that articulates what the client needs from their financial assets, as well a portfolio specifically crafted to fill those needs, is vital in addressing regulatory concerns. With Nebo Wealth, advisors are able to create bespoke portfolios in an open-architecture platform to grow and scale their business in a more efficient and compliant manner.

Matt Kadnar
Sales Lead
Nebo Wealth

Martin Tarlie
Product Lead
Nebo Wealth

Legal and regulatory risk is anywhere and everywhere these days. Specifically, suitability risk can be very important for advisers, particularly those with portfolio construction processes that are less well defined. The SEC Office of Compliance Inspections and Examinations observed that "more than half" of the advisors examined were cited for deficiencies related to portfolio management practices.[2] Why are clients with very different financial circumstances in the same portfolio? Why are clients with very similar financial circumstances in different portfolios? How did the adviser determine and monitor the client asset allocations? Advisers that cannot readily respond to these questions leave themselves exposed to a variety of risks ranging from regulatory enforcement to client-facing liability. Firms with multiple advisor teams and offices face enhanced scrutiny from the greater heterogeneity of advisor practices, either through "rep as PM" or the use of different models among teams.

Through a comprehensive Investment Policy Process ("IPP"), advisors utilizing the Nebo Wealth platform create bespoke portfolios based on each client's goals

[1] The authors would like to thank Douglas Charton of GMO for his contributions to this paper.

[2]Winston & Strawn, "OCIE Identifies Common Compliance and Supervisory Deficiencies of Investment advisors," *Client Alert,* December, 2020, https://www.winston.com/en/insights-news/ocie-identifies-common-compliance-and-supervisory-deficiencies-of-investment-advisers

and circumstances. The platform systematically builds a portfolio optimized to maximize the likelihood of achieving the unique goals outlined in the IPP. This process helps the advisor answer these potentially tough questions in the face of regulatory and client scrutiny.

Why are the vast majority of your clients in the same ”moderate” allocation? Fortunately, Nebo Wealth provides a process to clearly answer these questions

Regulatory Focus on Asset Allocation

The importance of asset allocation in achieving client outcomes ranges from “very important” to “incredibly important.” We polled advisors on the importance of establishing a client’s optimal asset allocation using a scale of 1-100, with 1 being least important and 100 being most important. The median response was 92. It’s difficult to conceive advisors agreeing so strongly on any topic, yet when it comes to the importance of asset allocation, they do. Given asset allocation’s significance, it is no surprise that the proverbial finger-in-the-air approach is raising additional compliance questions.[3] In our discussions with advisors, we have seen a wide variety of portfolio construction methods including those (1) utilizing highly flawed risk score methodologies,[4] (2) lacking in customization, and (3) leaning heavily on advisor intuition. Of course, with years of experience, many advisors can have excellent intuition. The problem with this approach is that it is difficult to document and not systematic as intuition, unfortunately, can be a fickle thing at times. Other advisors utilize models which, though good in theory, end up lumping most clients in the ”moderate” model. These models also lack the ability for the advisor to really customize these portfolios based on a client’s unique needs and circumstances, not to mention the challenge of explaining why 90% of your clients are in the same moderate model.

These advisers may likely find themselves in difficult situations when facing more of those pesky suitability questions from clients and regulators. Why is Client A in the same 60/40 portfolio as Client B when Client B has a very different time horizons and financial needs yet has the same exact allocation? Why are the vast majority of your clients in the same ”moderate” allocation? These issues are likely to intensify as client demands for more personalization

[3] Michelle Atlas-Quinn, J.D., “Don’t Be a Statistic: 10 Compliance Fails That Can Sink Your RIA,” *Advisor Law*, June 21, 2024, https://advisorlawllc.com/dont-be-a-statistic-10-compliance-fails-that-can-sink-your-ria/.
[4] *See,* “The Perils of Outsourcing Asset Allocation to a Risk Score”, *Nebo Wealth*, June 2024; “Risk Scores – Putting the Horse Behind the Cart”, *Nebo Wealth*, August 2024.

increase. Fortunately, Nebo Wealth provides a process to clearly answer these questions.

In firms with a large number of advisors, the issues are slightly different. Within the large firms or aggregators, home offices must balance firmwide risk management concerns with promises of advisor autonomy in the recruiting process. Complete autonomy or "rep as PM" creates issues for the home office due to the potential inconsistency of advisor intuition as discussed above. Adding more and more models to your platform eventually leads to a glut of models, which can create operational issues, tracking and due diligence concerns, and technological headaches. Providing advisors with the tools they need to build personalized portfolios in a systematic fashion helps balance the larger risk management concerns of the home office in a less heavy-handed way that is more appealing to advisors.

The Increasing Importance of Illiquid Assets

We are also seeing the increasing importance of private assets in client portfolios. The illiquidity characteristics of private assets render most existing portfolio construction frameworks structurally unable to adequately model and account for such investments. Many illiquid assets have dynamic cash flows with a "commit/call" structure in which commitments are made up front and then called upon over a period of time. Once you are committed, you are committed. An allocation cannot be resized because of a change in financial circumstances or market conditions. A client (and by extension, their advisor) who has not adequately planned for the liquidity required in these structures is generally considered in default and may be subject to penalties and other legal liabilities. Given the seriousness of such liquidity issues, regulators are focusing on the advisor's duty of care in recommending illiquid assets in their examinations[5]. A robust portfolio tool that provides an appropriately sized allocation to illiquid investments will not only help improve client outcomes, but it will also reduce suitability risk.

To address these illiquidity issues, many advisors are utilizing interval funds, which typically have quarterly liquidity and lower minimums. The primary benefit of such funds being avoidance of the "commit/call" structure and greater liquidity relative to other limited partnerships. While interval funds do offer more liquidity than traditional LPs, it is not the same thing as investing in a traditional mutual fund or ETF. An interval fund experiencing excessive redemptions can usually place gates or limit redemptions, making it much more difficult to get your money out in a timely fashion. It's not quite getting blood from a stone, but it is not a great position to be in if you need short-term liquidity.

We have seen some firms building lines of credit to help with short-term liquidity for individuals, but the question of "what is the optimal allocation to

[5] "SEC 2024 Examination Priorities Indicate Increased Scrutiny of Investment Advisers and Continued Focus on Cybersecurity, FinTech and Anti-Money Laundering Programs", O'Melveny & Myers, LLP, December, 2023.

illiquid assets?" remains unanswered. What is your process for determining the allocation? Having a robust portfolio tool to make that recommendation will become increasingly important as illiquid assets become a larger portion of every advisor's arsenal of strategies. This applies to both managing a client's portfolio and reducing regulatory risk.

The Solution

Building a portfolio directly linked to a client's unique financial goals goes a very long way toward answering the "why" questions a regulator or client may ask. Nebo Wealth operationalizes an IPP that better balances the client's unique time horizon, risk tolerance, cash flows, legacy goals, and target return necessary to achieve the client's goals and objectives. Coherently connecting these elements of the IPP requires a fundamental change in thinking. Instead of thinking of risk as volatility, which is what we are all taught in our Finance 101 class, we should think of risk much more practically: that you don't have what you need, when you need it. We operationalize this concept of risk using an optimization engine designed to take all the elements of the IPP into consideration in order to maximize the likelihood the client achieves their goals.

In the Nebo Wealth IPP Process, we take all the unique needs of a client and build the perfect-fit portfolio for each stage of the client's financial journey. If the client's goals and objectives change, the portfolio changes in a fluid yet systematic manner. This process takes into account the dynamic nature of both client circumstances and the market by re-optimizing to efficiently produce a portfolio directly connected to the client's evolving financial goals. The result is a clear rationale for why each client owns what they own – including illiquid assets. The advisor understands precisely what they need to believe about the client and the market to recommend a portfolio for the client. This process is then documented and stored in the advisor's CRM system so when the regulator comes calling, the advisor can answer the critical "why" questions. The appeal for smaller firms is simple and direct: improving client outcomes and reducing compliance risk. For larger firms, this approach aids in the balance between enterprise-wide risk management and advisor autonomy.

Three Birds, One Stone

From the headlines, it appears regulatory risk is increasing each day for advisors, many of whom may be more exposed than they realize when it comes to the suitability of their portfolio construction and related practices. A clear process that articulates what the client needs from their financial assets, as well a portfolio specifically crafted to fill those needs, is vital in addressing regulatory concerns. The Nebo Wealth IPP does just that, enabling advisors to:

- create bespoke portfolios (bird one),
- preserve their investment identity through an open architecture platform (bird two), and
- scale their business in a more efficient way (bird three).

Creating better outcomes for clients is part and parcel of this process. And while it may not solve all of your compliance challenges, we believe it is a good place to start.

Nebo Wealth
53 State Street
33rd Floor
Boston, MA 02109

www.nebowealth.com