

Authors:

Michael S. Caccese

+1.617.261.3133

michael.caccese@klgates.com

Lance C. Dial

+1.617.951.9104

lance.dial@klgates.com

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SEC Staff Issues First ComplianceAlert Newsletter

SEC Investment Adviser Examination Issues

On June 14th, 2007, the staff of the Securities and Exchange Commission (“SEC”) issued its first *ComplianceAlert* letter to educate compliance officers about some common compliance deficiencies and weaknesses that the SEC staff (“Staff”) encounters during its routine examinations. The *ComplianceAlert* series is designed to encourage firms to review their compliance efforts and implement improvements when appropriate. Each letter will summarize select areas SEC examiners have recently reviewed during examinations and describe the issues raised. The Staff plans to issue additional *ComplianceAlert* letters on the SEC web site (<http://www.sec.gov>).

The first *ComplianceAlert* letter addressed a variety of topics affecting investment advisers, mutual funds and broker-dealers including investment adviser disaster recovery plans, closed-end fund distributions, and mutual funds’ “as-of” transaction practices. The letter also included considerable discussion relating to investment adviser performance advertising, outlining the results of a recent risk-targeted examination review. The Staff identified a number of deficiencies with respect to adviser advertisement of performance returns. The most frequently cited deficiency was insufficient disclosure to prevent the advertisement from being misleading. In the *ComplianceAlert* letter, the Staff provided a list of common performance advertising deficiencies, including:

- inappropriately advertising a partial list of past specific recommendations;
- not disclosing whether performance results reflected the reinvestment of dividends and other income;
- not disclosing material facts relating to the comparison of adviser performance returns to a benchmark;
- providing insufficient disclosure for “hypothetical returns” in performance claims; and
- providing insufficient disclosure regarding portability (advertising a prior adviser’s performance record).

Another common deficiency was advisers’ inaccurate claims of compliance with the Global Investment Performance Standards (“GIPS”) issued by the CFA Institute. While the majority of examined advisers claimed compliance with GIPS, the Staff found only one adviser was actually in full compliance, even though most advisers had previously had their methodology and calculations verified by a third-party GIPS verification firm. This finding serves as a reminder that advisers should not rely solely on third-party verifiers to determine GIPS compliance.

In addition, the Staff found that many advisers lacked sufficient compliance policies and procedures regarding performance advertising and marketing. Inadequate policies and procedures did not:

- address the operations or practices of the adviser's businesses;
- ensure that third-party consultants used compliant presentations;
- address the methods the adviser used to treat cash (and equivalents) when "carving out" separate equity and fixed income performance from balanced accounts;
- ensure the adviser was in compliance with all applicable GIPS requirements prior to making a claim of such compliance;
- require a consistent comparison of composites to appropriate benchmarks; and
- ensure accurate composite descriptions.

The Staff also provided examples of effective advertising policies and procedures, including:

- a multi-level review process among an adviser's performance group, portfolio managers, and marketing group for the accuracy of marketing materials prior to their use;
- the creation of "tolerance reports" on a monthly basis to compare all composite accounts to their respective benchmarks, with any material discrepancies being investigated;

- a composite committee review of all accounts on at least a quarterly basis to ensure proper composite construction and maintenance;
- the use of a second independent pricing service to periodically verify the accuracy of prices supplied by the primary pricing service, with any material discrepancies in prices being investigated;
- the use of some type of "hypothetical return" number in performance claims, coupled with supplemental explanatory disclosure; and
- the increased use of automated software programs to calculate performance, which appears to reduce inadvertent errors in the calculation of performance results.

The *ComplianceAlert* series will address many areas of SEC interest and will enable SEC-registered firms to identify deficiencies and improve their compliance programs with respect to many areas. This first *ComplianceAlert* letter, among other compliance areas, reminds investment advisers to vigilantly monitor their advertising and policies and procedures to ensure compliance with federal law and GIPS (as appropriate).

The ComplianceAlert newsletter is available in full on the SEC's website at: <http://www.sec.gov/about/offices/ocie/complialert.htm>.

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