



How to Prepare for an SEC Examination

Presented by:

Cary J. Meer

Marc Mehrespand

Michael J. Missal

Lawrence B. Patent

William A. Schmidt

K&L Gates
November 19, 2008

Contents

Tab 1

Speaker Biographies

Cary J. Meer

Marc Mehrespand

Michael J. Missal

Lawrence B. Patent

William A. Schmidt

Tab 2

Powerpoint Presentation

Tab 3

Guidelines for Responding to SEC Staff in Connection with Onsite Examinations

Tab 4

SEC Examinations of Hedge Fund Managers

Tab 5

SEC Master Information Request List (for non-sweep exams)

Tab 6

"Incentivising Good Compliance"; Lori A. Richards, October 30, 2008

Tab 7

"Compliance Through Crisis: Focus Areas for SEC Examiners and Compliance Professionals"; Lori A. Richards, October 21, 2008

Tab 8

CCOutreach 2007 Regional Seminars

Tab 9

Questions Advisers Should Ask While Establishing or Reviewing Their Compliance Procedures, SEC, May 2006

Tab 10

NFA Annual Regulatory Reminder for Commodity Pool Operators

Tab 11

NFA Annual Regulatory Reminder for Commodity Trading Advisors

Tab 12

Office of Compliance Inspections and Examinations: Investment Adviser Examinations – Core Initial Request for Information





Cary J. Meer

AREAS OF PRACTICE

Ms. Meer is a partner in K&L Gates' Washington, D.C. office. Her principal areas of concentration are corporate, securities and commodities matters. In particular, she has focused her practice on private investment companies or hedge funds, negotiated mergers and acquisitions of operating companies, as well as investment advisers and broker-dealers, derivatives and related areas.

WASHINGTON, D.C. OFFICE

202.778.9107 TEL

202.778.9100 FAX

cary.meer@klgates.com

Ms. Meer structures hedge funds as limited liability companies, limited partnerships, common trust funds and business trusts, and prepares disclosure documents and organizational documents for such entities. She also advises investment advisers, private fund managers and investment companies on compliance issues, including under the Investment Advisers Act of 1940 and whether their futures-related trading or advice brings them within the regulatory structure of the Commodity Exchange Act and, if so, with respect to their obligations under the regulations of the Commodity Futures Trading Commission and the National Futures Association.

- Co-author, "CFTC Amendments to the CPO and CTA Disclosure Rules," *The Review of Securities & Commodities Regulation*, January 10, 1996.
- "How Money Managers May Avoid the CFTC's Commodity Trading Advisor Requirements," *The Investment Lawyer*, October 1995.
- Co-author, "Tab 900 - Regulation of Commodities," *Money Manager's Compliance Guide*, 1994, 1995, 2005.
- "Hybrid Instruments: Their Treatment Under Recent Commodity Futures Trading Commission Releases," *Business Law*, February 1991.

BAR MEMBERSHIP

District of Columbia
New York

EDUCATION

J.D., Harvard Law School, 1982 (*cum laude*)

B.S., University of Pennsylvania, Wharton School, 1979 (*summa cum laude*)



Marc Mehrespand

AREAS OF PRACTICE

Mr. Mehrespand is a partner in the securities and investment management groups. He represents investment advisers, banks, broker-dealers and other participants in the financial services industry in a practice that encompasses the major federal securities and commodities laws as well as general corporate law. In particular, Mr. Mehrespand regularly works with clients to form and operate U.S. and offshore private investment funds. Mr. Mehrespand also:

- Registers newly-formed investment advisers, commodity pool operators, commodity trading advisers and investment companies.
- Prepares organizational and disclosure documents for private and public offerings of securities and the sponsors of such offerings.
- Creates private funds structured as employees' securities companies.
- Advises clients that deal with futures contracts and options on futures contracts on applicable provisions of CFTC and NFA regulations.
- Represents clients before the SEC on a broad range of corporate and securities law issues such as proxy contests and investment adviser examinations.
- Advises broker-dealers and clients working with broker-dealers on relevant NASD regulations.
- Structures executive employment and compensation arrangements.
- Has advised regulators outside of the United States on securities and corporate law reforms in those countries.

BAR MEMBERSHIP

District of Columbia
Maryland

EDUCATION

J.D., The George Washington University Law School, 1998
M.A. (International Affairs), The George Washington University, 1998
B.A., George Mason University, 1994

WASHINGTON, D.C. OFFICE

202.778.9191 TEL
202.778.9100 FAX
marc.mehrespand@klgates.com



Michael J. Missal

AREAS OF PRACTICE

Mr. Missal concentrates in securities enforcement matters, internal investigations and broker-dealer regulation. He represents a number of public and private companies, and their officers and directors, on a variety of regulatory and corporate governance matters. Mr. Missal regularly appears before the Securities and Exchange Commission, the Financial Industry Regulatory Authority, the Department of Justice, state attorney generals and state securities regulators. Some of his more significant matters include:

- Examiner in the New Century Financial Corporation bankruptcy proceeding, one of the largest subprime lenders. Investigated a number of issues, including accounting and financial reporting irregularities and the potential use of post-petition cash collateral.
- Lead Counsel to the Independent Review Panel for CBS investigating the September 8, 2004 60 Minutes Wednesday segment concerning President Bush's Texas Air National Guard Service.
- Representation of numerous public companies, broker-dealers, investment advisors, officers and directors in securities regulatory investigations before the SEC, DOJ, FINRA, state attorney generals and state securities regulators. Recent matters have included issues of insider trading, financial reporting and disclosures, potential conflicts of interest between the research and investment banking departments and mutual fund market timing.
- Lead Counsel to the Examiner in the WorldCom bankruptcy proceeding. Led team of lawyers and accountants investigating a number of issues, including accounting and financial reporting irregularities, WorldCom's relationships with investment bankers and auditors, loans to senior officers, WorldCom's acquisitions and the fiduciary duties of WorldCom's officers and directors.
- Representation of Michael Milken in an SEC action regarding a potential violation of a previous court order enjoining him from associating with a broker-dealer.
- Advice to Boards of Directors of various public companies on corporate governance issues
- Appointment as escrow agent and trustee by various federal courts for several multi-million dollar SEC disgorgement funds.

PROFESSIONAL BACKGROUND

- Partner, K&L Gates, 1987-Present
- Practice Area Leader, K&L Gates Management Committee, 1998-Present
- Senior Counsel, Division of Enforcement, Securities and Exchange Commission, 1983-1987
- Law Clerk, Chief Judge H. Carl Moultrie, District of Columbia Superior Court, 1983
- Staff Assistant, President Jimmy Carter, 1978-1980

PUBLICATIONS

- Investigating the Insider, *Security Management*, by Michael J. Missal, Andrew H. Feller, October 2008

WASHINGTON, D.C. OFFICE

202.778.9302 TEL

202.778.9100 FAX

michael.missal@klgates.com

Michael J. Missal

- Conducting Corporate Internal Investigations, *International Journal of Disclosure and Governance*, November 2007, Vol. 4 No. 4
- Co-Editor and Contributing Author, The Securities Enforcement Manual, Second Edition, *ABA Section of Business Law*, 2007.
- Co-Author, Improve Corporate Governance, *The Brookings Institute Opportunity 08*, 2007.
- Co-Author, “The SEC’s New Executive Compensation Disclosure Rules: Liability Concerns for Officers and Directors,” *Andrews Litigation Reporter*, September 18, 2006.
- Co-Author, “The Foreign Corrupt Practices Act: US Legislation with Global Implications,” *Cross-Border Quarterly*, April 2006.
- Co-Author, “Where the Buck Stops,” *European Lawyer*, September 2005,
- Co-Author, “Six Lessons From WorldCom,” *Corporate Counsel*, September 2004.
- Co-Author, “Manage Your CEO – or Else,” *Chief Legal Executive*, Fall 2003.
- “When the SEC Comes Calling,” *ACCA Docket*, April 2001.

PROFESSIONAL/CIVIC ACTIVITIES

- NASDAQ Market Operations Review Committee, 2001 to 2006
- Chairman, Broker-Dealer Regulation and Securities Enforcement Committee, Dist of Columbia Bar Association, 1995-1998
- Lectured to the Russian Federal Securities Commission and the National Association of Securities Market Participants in November 1999 as part of the Financial Service Volunteer Corps.

BAR MEMBERSHIP

District of Columbia

EDUCATION

J.D., Catholic University, 1982 (Staff Member, Catholic University Law Review)
B.S., Washington and Lee University, 1978



Lawrence B. Patent

WASHINGTON, D.C. OFFICE

202.778.9219 TEL

202.778.9100 FAX

lawrence.patent@klgates.com

AREAS OF PRACTICE

Larry Patent is of counsel in the firm's Washington, D.C. office. His principal areas of concentration are investment management, commodity futures, financial services and derivatives matters.

Mr. Patent's experience includes substantial involvement with all of the Commodity Futures Trading Commission (CFTC) regulations related to intermediaries, including registration and fitness, sales practices, disclosure, reporting, recordkeeping, minimum financial requirements, customer funds protection, international trading, foreign currency, anti-money laundering, bankruptcy, risk assessment and managed funds.

PROFESSIONAL BACKGROUND

Prior to joining K&L Gates, Mr. Patent served as deputy director of the Division of Clearing and Intermediary Oversight at the CFTC. Mr. Patent worked at the CFTC in various capacities for more than 30 years.

PRESENTATIONS

- "Soup to Nuts," opening panel at Futures Industry Association Law & Compliance Division Annual Workshop
- "Regulatory Developments," Forex Traders Expo
- "Cross-Border Regulatory Issues," Equity Options Program
- "Introduction to the Commodity Exchange Act," various visitors to CFTC

PROFESSIONAL/CIVIC ACTIVITIES

- Little League Coach in Challenger Division, Arlington, Virginia

COURT ADMISSIONS

- U.S. District Court for the District of Columbia

BAR MEMBERSHIP

District of Columbia

EDUCATION

J.D., Georgetown University Law Center, 1977

B.A. Williams College, 1974 (*cum laude*)

REPRESENTATIVE EXPERIENCE

- Principal drafter and interpreter of commodity option regulations and introducing broker regulations.
- Represented CFTC in meeting with other federal financial regulators.



William A. Schmidt

WASHINGTON, D.C. OFFICE

202.778.9373 TEL

202.778.9100 FAX

william.schmidt@klgates.com

AREAS OF PRACTICE

Mr. Schmidt works in the areas of institutional investing and employee benefits, with particular emphasis on fiduciary responsibility matters under the Employee Retirement Income Security Act of 1974 (“ERISA”). Mr. Schmidt advises major financial institutions, including banks, insurance companies, registered investment advisers and large employee benefit plans about ERISA restrictions relating to plan investments and to fee arrangements for investment management and plan administrative services.

PROFESSIONAL BACKGROUND

Mr. Schmidt was formerly Counsel for Regulation in the Plan Benefits Security Division of the Office of the Solicitor of the U.S. Department of Labor, where he was responsible for providing legal advice with respect to the Department's regulatory, interpretive and legislative activities under ERISA. Mr. Schmidt serves as an Adjunct Professor of Law at Georgetown University Law Center.

PRESENTATIONS

Mr. Schmidt writes and speaks extensively on employee benefit issues.

PROFESSIONAL/CIVIC ACTIVITIES

- American College of Employee Benefits Counsel (Charter Fellow)
- Board of Editorial Advisors of the *Benefits Law Journal*, *Journal of Pension Planning and Compliance* and *The Investment Lawyer*

COURT ADMISSIONS

- Court of Appeals for the District of Columbia
- U.S. Court of Appeals for the Federal Circuit
- U.S. Court of Appeals for the Ninth Circuit

BAR MEMBERSHIP

Connecticut
District of Columbia

EDUCATION

LL.M. (Taxation), Georgetown University Law Center, 1983
J.D., University of Virginia School of Law, 1973
B.A., University of Virginia, 1970 (with high honors)



How to Prepare for an SEC Examination

Cary J. Meer
Marc Mehrespand
Michael J. Missal
Lawrence B. Patent
William A. Schmidt

DC-1270910-v2

November 19, 2008

www.klgates.com

Cary J. Meer, Partner, Washington, D.C.



Ms. Meer advises hedge fund and fund-of-funds managers on the organization and structuring of private investment funds, as well as on compliance issues, including under the Investment Advisers Act of 1940 and whether their futures-related trading or advice brings them within the regulatory structure of the Commodity Exchange Act. She is also active in negotiating and structuring acquisitions and dispositions of hedge fund managers, investment advisers, broker-dealers, administrators and other financial services firms, and strategic alliances and joint-ventures with financial services participants.

Marc Mehrespand, Partner, Washington, D.C.



Mr. Mehrespand is a partner in the securities and investment management groups. He represents investment advisers, banks, broker-dealers and other participants in the financial services industry in a practice that encompasses the major federal securities and commodities laws as well as general corporate law. In particular, Mr. Mehrespand regularly works with clients to form and operate U.S. and offshore private investment funds.

Michael J. Missal, Partner, Washington, D.C.

Mr. Missal concentrates in securities enforcement matters, internal investigations and broker-dealer regulation. He represents a number of public and private companies, and their officers and directors, on a variety of regulatory and corporate governance matters. Mr. Missal regularly appears before the Securities and Exchange Commission, the Financial Industry Regulatory Authority, the Department of Justice, state attorney generals and state securities regulators.

Lawrence B. Patent, Of Counsel, Washington, D.C.

Mr. Patent's principal areas of concentration are investment management, commodity futures, financial services and derivatives matters. Mr. Patent's experience includes substantial involvement with all of the CFTC regulations related to intermediaries, including registration and fitness, sales practices, disclosure, reporting, recordkeeping, minimum financial requirements, customer funds' protection, international trading, foreign currency, anti-money laundering, bankruptcy, risk assessment and managed funds. Mr. Patent spent 30 years of his legal career at the CFTC. He most recently served as the Deputy Director of the CFTC's Division of Clearing and Intermediary Oversight.

William A. Schmidt, Partner, Washington, D.C.

Mr. Schmidt works in the areas of institutional investing and employee benefits, with particular emphasis on fiduciary responsibility matters under ERISA. Mr. Schmidt advises major financial institutions, including banks, insurance companies, registered investment advisers and large employee benefit plans about ERISA restrictions relating to plan investments and to fee arrangements for investment management and plan administrative services.

Overview

- Introduction
- The Process
- Preparation
- While the SEC is in Your Office
- Possible Outcomes
- Hot Areas

Introduction

- Types of examinations
 - Routine – high-risk cycle and low-risk cycle
 - For Cause – driven by a firm-specific issue
 - Sweep – driven by an industry issue
- What is the SEC staff looking for?
 - Assessment of compliance program
 - Understanding of the firm
 - Document review
- Who conducts SEC examinations?
 - Office of Compliance Inspections and Examinations (OCIE)

Introduction (Cont.)

- What can trigger an SEC exam?
- How are SEC examinations evolving?
- How are the triggers and timing for CFTC/NFA examinations different?

The Process

- What does a document request look like?
 - SEC
 - NFA
 - DOL
- Organization of production of documents
- Attorney-client privilege

Preparation

- Thinking strategically about an SEC examination
 - Compliance risk assessments
 - Testing
 - “Outputs”
- Mock SEC audits
- Tone at the top
- Preparing your personnel for an examination
 - Preserving and producing documents

Preparation (Cont.)

- Preparing your personnel for SEC interviews
 - Answering directly, calmly, honestly, politely
 - Staying on topic
 - Addressing any issues upfront
- Managing the interview process
- The importance of training

While the SEC is in Your Office

- Managing the staff's presence in your office
 - Interacting with the staff
 - Where to set them up
- Managing the process
 - Appoint a coordinator
 - Present the senior management first
 - Keep it moving along
- The importance of honesty and keeping your promises
 - Embodying the compliance culture
- Arguing your case without alienating the staff

While the SEC is in Your Office (Cont.)

- Freedom of Information Act
- Exit Interviews
- What if the process becomes antagonistic?

Possible Outcomes

- Nothing
- Deficiency Letter
- Enforcement Referral

Responding to a Deficiency Letter

- The importance of responding:
 - Otherwise, the staff considers its assertions uncontested
 - Potential for referral to enforcement
- Decide which cited deficiencies to accept and to contest
- For those you contest, clearly set forth your reasons:
 - Legal arguments and interpretations of relevant authorities
 - Set the factual record straight, diplomatically but clearly
- For those you accept:
 - Explain mitigating circumstances
 - Set forth remedial measures that you will take
- Keep your promises

Handling Violations

- The goal: deal with potential violations without creating a roadmap to an enforcement action
- Think strategically about the “audit trail”
 - How will it appear to the SEC after the fact?
 - Does it commit my firm to any specific actions?
- The 5-step program:
 - Investigate
 - Deliberate
 - Judge carefully
 - Reflect on lessons learned
 - Try to prevent future issues
- Enforcement referrals

Hot Areas

- Non-Compliance with Compliance Procedures
- Marketing Materials and Performance Presentation
- Conflicts of Interest – Allocations of Trades, Soft Dollars, Use of Affiliates
- General Solicitation
- Referral Arrangements
- Compliance with Side Letters
- Best Execution
- Personal Trading/Code of Ethics and Insider Trading, Rumors and Manipulation
- Valuation

Personal Trading/Code of Ethics

- The importance of implementing and enforcing your firm's code of ethics
 - For the SEC, a bellwether of a firm's culture of compliance
 - If a star PM or the CEO consistently refuses to seek preclearance, how do you deal with it?
- Using the freedom to tailor your code, based on a risk calculus:
 - When to use pre-clearance, trading prohibitions and blackouts
 - Determining access persons
- Testing and documenting compliance with the code
 - Violations and sanctions: consistency and proportionality
- Recent SEC enforcement actions/deficiency letters address:
 - Failure to preclear
 - Failure to tailor "prepackaged" code
 - Market timing and front-running firm's own funds

Insider Trading, Rumors and Manipulation

- The global war on insider trading
 - One of Cox Commission's primary enforcement priorities
 - The focus on investment/securities professionals
 - The focus on "social networks"
 - CFTC, FINRA activity
- Sweeping enforcement investigations into "rumor mongering" regarding financial stocks
 - Enforcement cases show concern that deliberate falsehoods by short sellers are driving stock prices down and resulting ban

Valuation

- Process matters. What is the staff looking for?
 - Written procedures and consistency in methodology
 - Independence, especially from portfolio managers
 - Valuation committee or process focused on accountants, administrators
 - Disclosure and documentation of process and potential outcomes
- Special issues in valuing fixed income instruments
 - Illiquidity
 - Matrix pricing
- Special issues with pricing sources
 - Pricing services: adequacy and transparency of methodology
 - Broker quotes: illiquidity, accommodation quotes, marking to market
- FAS 157 and the new “fair value”
 - Tier I, II and III securities and “active markets”
- SEC enforcement cases



Guidelines for Responding to SEC Staff in Connection with Onsite Examinations

Suggested guidelines for responding to the SEC staff once they have commenced their onsite examination include:

1. Establish one person as the primary contact with the SEC staff. This person should provide all documents requested by the staff and should be present at all meetings between the staff and any other employee of the adviser.
2. Provide the SEC staff with a workroom apart from the adviser's employees to minimize the staff's impact on ongoing advisory activities.
3. Extend common courtesies to the staff and, to the extent practicable, be cooperative, positive, cordial and responsive. However, do not volunteer information or documents that are not requested.
4. If a requested record is missing or has not been maintained, advise the SEC staff. If you need more time to locate a document or provide an explanation, advise the staff that there will be a slight delay.
5. Maintain a list and copies of all documents that the staff receives from the adviser and a list of all employees of the adviser with whom the staff speaks.
6. As a general rule, do not permit the SEC staff to remove original documents. If the staff insists (which is unlikely), be sure to keep an exact duplicate.
7. Do not alter documents requested by the staff in any way for any reason.
8. Try to prepare any person that the staff asks to interview just as you would prepare a witness who is going to testify in court. For example, remind the person not to speculate, not to offer answers to questions that are not asked, not to draw legal conclusions that he or she is not professionally qualified to make, and to ask for clarification if a question is not clear.
9. Inform all employees of the adviser of these guidelines. For instance, if an SEC staff member directly approaches an employee without the contact person being present, the employee will know to see the contact person.
10. After each interview, the primary contact person should prepare a memorandum to the file summarizing the relevant discussion that was just held.
11. Do not hesitate to ask for the opportunity to consult with legal counsel in private before responding to any information requests.
12. Do not admit that any conduct by the adviser constitutes a violation of law.

13. If producing requested records appears unduly burdensome, do not hesitate to ask the staff if it is possible to narrow the scope of the request.
14. At the end of an audit, but prior to the staff's departure, request an "exit interview" during which the staff provides its preliminary comments. The staff is not required to provide such interviews and sometimes chooses not to. However, it is a good forum for clarifying any misunderstandings that the staff may have and for ascertaining whether there are any problems that require immediate attention by the adviser.
15. After receiving a deficiency letter, attempt to remedy any deficiencies prior to submitting a response to the deficiency letter.
16. Be sure to implement all remedial actions indicated in your response letter to the staff. The next SEC inspection team will closely scrutinize the compliance with any such undertakings.
17. Advisers that have mutual fund clients should apprise the fund's board of directors of any staff comments that are relevant to the fund.
18. Consider requesting confidential treatment for any material that the staff takes away with them or is sent to them.



SEC EXAMINATIONS OF HEDGE FUND MANAGERS

RICHARD PHILLIPS
MARK PERLOW
MATT MANGAN

CREATING AN ACTION BLUEPRINT FOR TODAY'S EXAMINATIONS

A. Introduction

1. The SEC has express statutory authority only to examine the books and records of registered advisers; as a practical matter, the SEC staff also can and does use its inspection authority to gather information through requests for written submissions and informal interviews of officers and employees.
 - a. Insistence by a firm on strict observance of the statutory limitations is likely to result in a prompt issuance of a subpoena for sworn testimony before the SEC's Enforcement Division – in most circumstances a most undesirable escalation of a request for informal access to information.
 - b. The power to inspect is probably the most important (and intrusive) aspect of Adviser Act regulation because it enables the SEC to oversee not only technical regulatory compliance by registered advisers, but also the integrity of their representations to clients.
 - (i) The SEC evaluates compliance controls and risk profiles with a view towards preventing future violations.
 - (ii) Thus, the SEC is able to oversee the firm's activities well beyond the examination of reports and other filings with the Commission.
 - c. All registered investment advisers should expect periodic SEC inspections.¹

¹ For further discussions of the SEC's inspection power, *see e.g.*, SEC 2006 Performance and Accountability Report at 11, available at <http://www.sec.gov/about/secpar/secpar2006.pdf> ("2006 SEC Accountability Report"); Lori Richards, Director, OCIE Speech at 9th Annual IA Compliance Best Practices Summit 2007, IA Week and Investment Adviser Association: SEC's Compliance Examinations in the Protection of Investors (Mar. 23, 2007), available at www.sec.gov/news/speech/2007/spch032307lar.htm; keynote address at the National Regulatory Services, 17th Annual Spring Conference: Furthering Good Compliance: Current Areas of Focus in SEC Examinations (Apr. 8, 2002), available at <http://sec.gov/news/speech/spch548.htm> and Speech, "Meet the Regulators," Mid-Atlantic Securities Forum, Philadelphia, Pennsylvania (Mar. 21, 2002), available at <http://sec.gov/news/speech/spch545.htm>.

- d. The SEC's Office of Compliance Inspections and Examinations ("OCIE") conducts inspections of investment advisers, investment companies and broker-dealers as well as transfer agents and other regulated firms.² Also, a large number of broker-dealer inspections are conducted by FINRA and other industry self-regulatory organizations.
- e. Inspections are the most important source of enforcement investigations and actions against registered investment advisers and other securities firms.
- f. Accordingly, a thorough understanding of the inspection process is critically important for those who represent or are associated with registered investment advisers or investment companies and to avoid enforcement investigations and possible prosecution, as well as to be classified as "low-risk" and obtain the benefit of less frequent, less intrusive, and shorter inspections.

B. OCIE and the Inspection Program

- 1. Background. Historically, the SEC's inspection power was exercised through the SEC's Division of Investment Management for investment advisers and investment companies and the Division of Market Regulation for broker-dealers, transfer agents, clearing agencies, non-bank government and municipal securities dealers.³
 - a. On May 1, 1995, OCIE was created to centralize the oversight of all SEC inspection activities, and inspection staffs from the two Divisions were transferred to OCIE, and the inspection program was provided additional management and legal staff to coordinate and support the SEC's inspection program.
 - b. Most OCIE examiners are attached to regional offices, and their inspection related activities, although they report administratively to their office heads, are overseen by OCIE officials.
 - c. The result has been a much better trained, coordinated and supervised inspection staff which has as its primary mission not only the detection of fraud and other violations of the federal

² 2006 SEC Accountability Report at 12, *supra* note 1

³ At present, the SEC has 11 regional offices, including six offices that until recently were designated district offices and reported to regional offices.

securities laws but also the fostering of pro-active private sector compliance.”⁴

2. Types of Inspections

a. Routine Examinations. The SEC relies heavily on “routine” examinations that involve inspections on a schedule determined by both the passage of time since a firm has last been examined, and more importantly by the “risk profile” of the firm, *i.e.*, its compliance record, size and the staff’s perception of the compliance culture. Routine examinations represent the vast majority of SEC inspections.

(i) In 2006, almost two-thirds of the routine examinations were of higher risk investment advisers, and the rest were directed at randomly selected firms with low-risk profiles.⁵

(ii) OCIE focuses its limited resources on high compliance risk areas.

(a) Since routine examinations are not all encompassing, the examiners tend to focus on operational areas that are perceived as posing the greatest compliance risk, both within the industry and within firm being examined.

(b) Many of the current industry-wide areas can be readily identified from recent speeches by OCIE officials as well as from recent SEC enforcement actions.⁶

b. Cause Examinations. OCIE also conducts so-called “cause” examinations which are focused on potential specific violations

⁴ See Lori Richards, Director, OCIE, Remarks at the 9th Annual IA Compliance Best Practices Summit 2007, IA Week and the Investment Advisor Association: SEC’s Compliance Examinations in the Protection of Investors (Mar. 23, 2007), available at <http://www.sec.gov/news/speech/2007/spch032307lar.htm>; and keynote address at the National Regulatory Services, 17th Annual Spring Conference: Furthering Good Compliance: Current Areas of Focus in SEC Examinations (Apr. 8, 2002), available at <http://www.sec.gov/news/speech/spch548.htm>.

⁵ The SEC reported that in 2006 OCIE completed routine inspections of 650 advisers with higher risk profiles and 328 advisers with lower risk profiles. Such advisers accounted for approximately 40 percent of adviser assets under management as of the beginning of 2006. Examiners also conducted inspections of 368 advisers that appeared to have specific issues requiring additional scrutiny or that were part of a risk-targeted examination sweep. 2006 SEC Accountability Report at 11-12, *supra* note 1.

⁶ See *e.g.*, Lori Richards, Director, OCIE, Remarks at the 9th Annual IA Compliance Best Policies Summit 2007, IA Week and the Investment Advisor Association: SEC’s Compliance Examinations in the Protection of Investors (Mar. 23, 2007), available at <http://www.sec.gov/news/speech/2007/spch032707lar.htm>; and speech before the National Membership Meeting of the National Society of Compliance Professionals (Oct. 19, 2006), available at <http://sec.gov/news/speech/2006/spch101906lar.htm>.

and are usually initiated on the basis of an investor complaint, employee or competitor tip, press report, review of the firm's Commission filings or other sources which indicate a possibility of violations. Cause examinations tend to be highly focused on the particular problem or problems which led to the examination.

- (i) Unlike routine examinations, which are scheduled in advance and are usually preceded by notice, cause examinations are generally unannounced.
- (ii) Cause examinations, in particular, require a careful response because of the potential for a referral to enforcement; they should be handled in close consultation with experienced enforcement counsel.

c. "Sweep" Examinations. "Sweep" examinations generally involve either requests for information, or visits to the firm, preceded or supplemented by requests for information that seek to determine whether the manner in which a sample of the industry is handling a particular regulatory compliance issue is cause for regulatory concern and possible further investigation.

- (i) Sweep examinations vary in scope and intensity but commonly require the collection and analysis of relatively large quantities of information within relatively short time frames.
- (ii) Sweep examinations also require a careful response with a view towards precluding further inquiry.

d. New Firm Examinations. OCIE has also begun a pilot under which the staff will conduct single-day "introductory" examinations of newly registered advisers.

C. The Inspection Process

1. Selection of Inspection Targets. The SEC's current risk-based approach was introduced in 2003 and now drives the selection of inspection targets as a function of a firm's risk profile.

- a. To set examination priorities and goals, SEC examiners generally identify what they believe to be the most significant risks to investors, other registrants and the securities markets.
- b. Similarly, the examination itself focuses on the firm's risk management compliance culture and internal control processes.

at random or based on their own schedule. According to OCIE, the staff generally gives advisers two weeks' notice.

- b. Since the SEC is not obligated to provide prior notice to a firm, the inspection can begin with a surprise visit by the examiners, although this is not typical for routine examinations.
3. Examination Phases. The examination consists of several phases, conducted both at firm and SEC offices.
 - a. Onsite Investigation. The on-site portion of the examination, known as the "fieldwork," generally begins on the date specified in the notice of the examination, starting with an "entrance interview" with the firm's personnel, typically the CCO and possibly other officials of the firm.
 - (i) While on-site, the examiners review the requested records and interview firm personnel. These interviews may consist of questions about the documents produced, specific policies and procedures, and conduct at the firm generally.
 - (ii) These interviews can play a critical role in the examiners' assessment of the firm's controls and risk environment.
 - b. Off-site Investigation. The examination continues off-site at the SEC's offices, where the examiners, sometimes for many weeks, continue to review documents and other information received from the firm.
 - (i) The examiners may make follow-up telephone calls – sometimes many weeks after the examiners complete the on-site portion of the examination -- to ask questions, request additional documents and request written responses to certain questions to support the firm's responses.
 - (ii) The examiners may use computer technology to analyze large volumes of data that the firm has produced.
 - (iii) They also may consult with supervisors as well as OCIE and other SEC headquarters staff, such as the Division of Investment Management.
 - (iv) For certain low-risk advisers not located close to SEC offices, OCIE staff will conduct examinations completely off-site, through telephone calls and document production.

- c. Exit Interviews. When the SEC's off-site review is complete, examiners often seek participation in an "exit interview," generally with the firm's senior management of the firm.
 - (i) These interviews can be conducted in person or by telephone, generally as determined by the SEC staff.
 - (ii) In the exit interviews, the examiners discuss their preliminary findings.
 - (iii) The exit interview is critically important; it provides the firm an opportunity to react quickly to adverse findings either by attempting to correct the examiners' perception of the facts and/or applicable law or by taking prompt corrective action to remedy problems. It is crucial that senior compliance officers and executives participate in the exit interview so that the firm's representatives have the knowledge to correct the staff or provide the firm's point of view and the authority to take appropriate corrective actions.
 - d. To facilitate the management and prioritization of sweep examinations and to better focus on-site examinations, the SEC staff also may contact firms between on-site examinations to ask questions by phone and/or request additional documents or written responses to questions on an expedited basis on specific issues, such as for a sweep examination.
4. The Inspection Outcomes. SEC examinations can result in several possible outcomes that range from no adverse findings at all to referrals to the SEC's Division of Enforcement for further action.
- a. *Generally.* In the vast majority of examinations, however, the outcome is the middle of the spectrum, in which the examined firm receives a deficiency letter.
 - b. For example, the SEC examined 1600 investment advisers and registered investment companies in 2006; 80% received deficiency letters, while 6% were referred to Division of Enforcement staff for further review.⁸
 - c. Deficiency letters detail the examiners' findings regarding the firm's violations of laws and/or regulations, supervisory deficiencies and control weaknesses.

⁸ SEC 2006 Accountability Report at 12, *supra* note 1.

- (i) These letters generally require the firm to respond to the SEC within 30 days of the firm's receipt of the letter with a detailed explanation of the steps the firm intends to take to address the issues that are identified in the deficiency letter.
 - (ii) The 30-day deadline is not inflexible, and firms should not hesitate to request an extension, if needed, since it is more important to respond adequately than quickly.
- d. The firm's response letter to a deficiency letter is the last critical phase of an examination. The letter affords the adviser an opportunity to correct facts that the staff has gotten wrong, provide the firm's competing interpretation of relevant legal obligations, and to explain any circumstances that the staff may have missed or slighted in its examination. If the firm does not respond to a cited deficiency, the staff will consider its views uncontested and will expect the firm to have taken all of the necessary and stated corrective steps by the time of the next examination. The response letter at a minimum can put the staff on notice that its interpretation of facts and law could be contested, and at best can persuade the staff to change its view.
- e. In general, a firm's response letter should, as appropriate, discuss in detail:
 - (i) the reasons why the firm believes that the examiners' findings are erroneous,
 - (ii) the firm's interpretation of relevant legal sources that the staff has cited as the grounds for any deficiencies or violations,
 - (iii) the explanations for any acknowledged deficiencies, and
 - (iv) most importantly, the steps the firm has taken or is taking to correct the cited deficiencies that the firm does not contest.
- f. If the firm promises to take any corrective action, the SEC will look for these actions during the next examination; if it finds that the firm has not followed through, there is a real possibility that OCIE will refer the matter to the SEC Enforcement Division. Thus, it is critical that the firm have an action plan to ensure that all of its promises to the SEC are kept. For example, a matrix can be established setting forth the corrective action, the steps necessary to implement it, the person or persons whose responsibilities it is to implement it, and date of completion. If

appropriate, the compliance team can hold periodic meetings to obtain reports on progress or completion.

g. Letters Closing the Examination

- (i) Where the examiners make no findings regarding the firm's practices, policies and procedures or otherwise, the examiners send the firm a letter that concludes the examination and states that no findings were made.
- (ii) This is obviously an exceedingly good but rare outcome. It happens only in a small percentage of the examinations.

h. Enforcement Referral

- (i) When examiners make a determination that the conduct, lack of supervision, policies or procedures or any other aspect of the firm's business may warrant further action by the SEC Division of Enforcement, OCIE will make an "enforcement referral."
 - (a) This determination is subjective and is made on a case-by-case basis, generally in consultation with the Division of Enforcement staff and the appropriate operating division.
 - (b) The decision may be reviewed by a committee of SEC staff from various divisions to determine whether a referral is appropriate given the facts and the applicable law.
 - (c) Conduct most likely to result in an enforcement referral includes violations that involve fraud, customer abuse, intentional wrongdoing and significant investor losses.
- (ii) An enforcement referral is likely to result in an enforcement investigation.
 - (a) Although in egregious cases such referral may occur promptly after or even before the close of the inspection, in most cases it occurs only after review of the firm's response to the deficiency letter.
 - (b) To reduce the potential of such a referral, it is critically important to respond to any of the concerns expressed by the examiners during the exit

interview if possible, and to respond thoroughly to the deficiency letter.

D. Handling the Inspection

1. The Essential Prerequisite: An Effective Compliance Program. Preparation for a positive SEC inspection must begin long before the commencement of the examination, with the establishment of a strong compliance culture at the firm.

- a. *Generally.*

- (i) An effective compliance program lies at the heart of a strong compliance culture. Such a program includes:
 - (a) Emphasis on compliance not only by compliance personnel, but also supervisory business personnel, management oversight committees, and boards of directors;
 - (b) a chief compliance officer and compliance staff with independence and integrity;
 - (c) clear accountability and responsibility for compliance matters;
 - (d) adequate resources devoted to compliance;
 - (e) compliance standards, policies and procedures, including a code of ethics or code of conduct;
 - (f) exercise of due diligence in delegating responsibilities;
 - (g) communication, education and training;
 - (h) monitoring and auditing;
 - (i) response, prevention and evaluation; and
 - (j) enforcement and discipline.⁹
- (ii) The firm's policies and procedures should address at a minimum portfolio management processes, trading practices for proprietary and employee personal trading, disclosures, safeguarding client assets, recordkeeping

⁹ See e.g., Lori Richards, Director, OCIE Speech before the National Membership Meeting of the National Society of Compliance Professionals (Oct. 19, 2006), available at www.sec.gov/news/speech/2006/spch101906lar.htm.

responsibilities, fee assessments, privacy and business continuity plans.

- (iii) Investment companies' compliance programs should also include valuation of portfolio securities, any pricing and processing of fund shares, identification of and policies with respect to transactions with affiliated persons, protection of nonpublic information, market timing and fund governance requirements.
 - (iv) Firms also should stay abreast of issues that the SEC staff considers "hot issues" and periodically review and update their compliance programs to the extent they have not adequately addressed these issues.
- b. *Tone at the Top.* A firm's culture emanates from the top. As such, senior management has a critically important role in establishing and maintaining a strong compliance culture by making compliance a priority for the firm. This can be accomplished in a variety of ways, including allocating appropriate resources for compliance operations and internal reviews and establishing and effectively communicating the consequences of violating policies and procedures.
- c. *Qualified CCO.* A qualified CCO is the *sine qua non* of a firm's compliance program.
- (i) Qualifications to be considered include the individual's:
 - (a) level of experience, especially as relevant to the risk, size and complexity profiles of the firm; and
 - (b) ability to establish, maintain and review the firm's compliance program, conduct mock examinations with the assistance of outside compliance consultants and law firms, and effectively manage relationships with regulators and firm management.
 - (ii) As discussed in more detail below, the CCO should have the stature necessary to effectively coordinate firm personnel for the SEC examination, and to be the primary interface with the SEC examiners during the inspection.
- d. *Effective Reporting and Documentation.* Effective recordkeeping is essential to an effective compliance program. It is also critical to a positive outcome of a SEC examination. If an action is not documented, OCIE staff will be skeptical that it was completed.

- (i) At a minimum, the firm must comply with applicable SEC and other recordkeeping requirements.
 - (ii) In addition, the SEC examiners will expect the firm to promptly provide the records requested initially and throughout the examination.
 - (a) The firm's ability to meet the examiners' requests quickly and with ease will help establish a positive first impression with the examiners and help demonstrate that the firm maintains effective control of its operations.
 - (b) Conversely, disorganized recordkeeping, inability to respond promptly to examiners' requests for documents and/or recordkeeping violations, even if minor, can create a negative impression regarding the firm's overall compliance.
 - (iii) A comprehensive recordkeeping matrix that identifies the regulatory records and other records that the firm otherwise maintains to support its business and the respective locations of the records will facilitate timely productions of the requested records.
 - (iv) A helpful exercise for firms with the resources is to conduct a "dry run" of document production for an SEC examination, either as part of a "mock" examination or as a standalone exercise. The compliance team can test the adequacy of the firm's records, their knowledge of their location, and the user-friendliness of records systems. Business staff can be trained and their expectations shaped about the need to produce SEC records promptly and completely.
- e. *Address Prior Deficiencies.* The SEC will expect firms to address deficiencies that were raised in prior examinations. The possibility of enforcement action is significantly enhanced if a firm fails to address prior criticism, especially if the criticism has been raised multiple times.

2. Managing the Process.

- a. Once the SEC examiners arrive at the firm, it is essential that the firm effectively manage the interactions with the examiners, production of records and responses to their questions. The examination will run more smoothly, and the firm will have better

- control over the process, if it designates a single contact for the examiners.
- b. Setting the right tone and evidencing a strong compliance culture from the outset will serve the firm well throughout the examination and ultimately could affect the outcome.
 - c. The firm's senior management can help demonstrate the priority it places on compliance by being available to meet with the examiners at the initial entrance interview, even if the SEC has not requested that they be present.
 - d. The person responsible for coordinating the examination for the firm should be someone who understands the examination process, the firm's compliance program and potential consequences of a mishandled examination.
 - (i) The exam coordinator's stature at the firm should be sufficiently senior so as to further evidence to the examiners the seriousness with which the firm considers the examination and compliance generally.
 - (ii) This person frequently will be the firm's CCO or general counsel or a senior member of their staffs.
 - e. Beginning the Exam
 - (i) At the outset of the examination, the firm's coordinator should introduce him or herself to the examiners and indicate to them that all requests for information, including requests to speak with the firm's personnel, should be made to the coordinator.
 - (ii) It also is important to designate a specific office or conference room where the examiners can perform their work. The workspace should be well-lit and have adequate space for the examiners to do their work. This will serve the dual purpose of making the examiners comfortable and limiting their access to employees.
3. All employees in the vicinity of the examiners' work room should be informed of the presence of the examination staff and instructed that all conversations should be conducted in private.
4. It is important at the beginning of the examination for the coordinator to ask the examination staff about the type of exam unless, as is often the case, the initial notice and/or request for documents before the examination begins provides this information.

5. The coordinator should inquire about the focus of the examination.
 - a. Although this may be evident from the initial document request, fully understanding the areas that the examiners will cover can be helpful to handling responses to the examination staff.
 - b. If the firm has any cause for concern about the scope of examination, the coordinator should inform the CCO (if the CCO is not the coordinator) and possibly the firm's legal counsel.
 - c. Consideration should be given to identifying any problem areas to the examiners before they find them on their own.
6. Since cooperation with the examination staff is key to a successful examination, responding promptly to examiners' requests is essential.
 - a. The coordinator should be responsible for overseeing the gathering, review and copying of all documents that the examiners request.
 - (i) All documents should be reviewed before they are given to examiners, to ensure that privileged and irrelevant materials are not provided.
 - (ii) The coordinator should confer with counsel before producing any documents if the coordinator or anyone else at the firm has any questions about the scope of the document request, including whether some of the documents may be privileged.
 - (iii) Requested documents and other information should be thoroughly examined prior to production from a regulator's viewpoint, and consideration given as to whether information that may raise questions should be accompanied with appropriate explanations.
 - (iv) Copies and/or records should be made of all documents that are produced, and careful notes should be taken of all interviews conducted.
 - (v) In other words, the firm should create an adequate record of the entire examination so as to be able to reconstruct the information that was provided to examiners, both in written form and orally.
 - b. Although a flat refusal to produce records to which the examination staff has a right to review is not wise, one should not hesitate to seek clarification of the scope of a request if the

- c. In OCIE's view, risk-based examinations facilitate the SEC's investor protection objectives through evaluations of both the investment advisory firms themselves and the conduct most likely to pose harm to investors.
 - (i) OCIE approaches its risk-based methodology for determining examination targets from several perspectives and processes.
 - (ii) OCIE asks examiners nationwide to identify what in their view are the most significant risks to investors, registrants and the markets.⁷
 - (iii) OCIE senior management uses this information to assist in setting examination program goals and priorities for individual firms, as well as to determine whether to conduct sweep examinations on specific activities.
 - (iv) OCIE's determination of firms to examine also is based on its analysis of "significant findings" from its prior examinations. OCIE also monitors news, new products and activities of firms, recurrent problems, trends and academic studies in determining target firms and conduct to examine.
 - (v) OCIE considers information it gathers from other SEC offices, including the Divisions of Enforcement, Investment Management, Market Regulation and Corporation Finance, and the Offices of Economic Analysis and Investor Education and Assistance (which receives and analyzes investor complaints). It also consults with bank, insurance and state securities regulators.
 - (vi) OCIE officials have stated that firms that the SEC designates as "high risk" can expect to be examined every three years. "Low risk" firms are randomly selected for examination.
- 2. Conduct of the Inspection. SEC inspections typically begin with a telephone call or letter from a regional office that specifies the date the examination is to begin and notifies the firm of documents that it must make available for inspection.
 - a. There is generally no way of knowing when the SEC will notify a firm of the examination. The examiners generally choose the date

⁷ Mary Ann Gadziala, Associate Director, OCIE, Remarks at the SIA Compliance and Legal Division June Monthly Luncheon: Regulatory Examination Programs—Focus and Significant Findings (June 22, 2006), available at <http://www.sec.gov/news/speech/2006/spch062206mag.htm>.

document request is unclear or will require production of an excessive number of documents.

- (i) Often the examination staff has no idea of the extent of documents that will be responsive to its request and can be persuaded to narrow it after being informed of the number of documents involved.
 - (ii) In any event, such a discussion can be invaluable in shedding light on the purpose of the staff's request.
7. Thorough preparation of employees who the examiners seek to interview is critical to successfully managing the examination, since well-prepared employees will be less nervous and better able to respond effectively to examiner questioning.
- a. The coordinator should also be the focal point for requests for interviews and preparing firm personnel who will be interviewed.
 - (i) Prior to any interview, the firm's CCO and/or legal counsel should meet with the employee to explain the interview process, offer guidance on what to expect and how to respond. In particular, senior management should be well prepared, since the SEC staff will be looking to them to determine the firm's "tone at the top."
 - (ii) All personnel with compliance responsibilities, including business staff, should understand that the SEC will be trying to determine how well they work together on compliance matters.
 - (iii) The person should be prepared for the interview as if testifying at an SEC investigation.
 - (a) The employee to be interviewed should understand the importance of being honest, calm, polite and cooperative.
 - (b) It is essential that employees understand that although they should be responsive to the examiner's questions, employees should not volunteer information that is not requested and never guess at an answer.
 - (c) Relevant personnel should be briefed on any compliance issues that the firm expects the SEC to focus on, so that they can demonstrate a command

of the issue, the firm's view of it, and any relevant sanctions imposed.

- (d) Ideally, each critical employee will be given a "practice" interview, *e.g.*, as part of a "mock" examination, so that they can learn to be comfortable in the spotlight.
- b. All interviews of firm employees should be attended by either legal or compliance department representatives to protect the employee's rights and to prevent the disclosure of irrelevant or privileged information.
 - (i) This will also assist the firm's understanding of the focus of the examination, enable it to assess potential issues or preliminary findings and to consider taking prompt remedial action during the pendency of the examination.
 - (ii) Careful notes should be taken during the interview or immediately afterward to maintain a record of the substance of the interview.
- 8. Facilitating an efficient process is key to handling an examination successfully.
 - a. Both the firm and the examination staff will benefit from an examination that runs efficiently. The sooner the examiners leave the firm's premises, the sooner the firm can resume business as usual.
 - b. The examination staff has its own schedule to keep and it benefits the firm to enable the staff to keep it. The longer the examiners remain at the firm's premises, the greater the likelihood of their uncovering something that might not have been a focus of the examination but that could provoke a deficiency letter.
 - (i) Accordingly, the firm should do whatever it can to enable the SEC staff to conclude the inspection as quickly as possible.
 - (ii) Responding promptly to the examiners' requests for information is a first step. In addition to moving the process quickly, prompt responses can leave the positive impression that the firm is well-organized, has recordkeeping under control and is otherwise well managed.

- (iii) The firm should provide affected personnel and any outside counsel with notice of an upcoming examination and the likelihood that they will be requested to review documents or be available for interviews on short notice so that there is no time lost in waiting.
9. The utmost candor is important since false or misleading statements to an examiner can not only undermine the firm's credibility, but they are also a federal criminal offense if deliberately made.¹⁰ Several steps will enable the firm to maintain its candor with the examination staff.
- a. All personnel should be honest with examiners. Regulatory problems can only become more serious if personnel are not truthful about the firm's activities.
 - b. Requests that relate to troublesome matters should be called to the examiners' attention before they are independently discovered.
 - c. The examiners tend to be more understanding of conduct that constitutes a violation of the rules when firms inform the examiners that the firm has discovered such conduct and the steps the firm has taken to correct it.
 - d. Such disclosures should be made only after careful consideration with experienced enforcement counsel.
 - e. Commitments made to the SEC staff, particularly those made in response to deficiency letters, should be fulfilled.
 - f. Failure to correct conduct cited in a deficiency letter can leave the staff with a variety of negative impressions, including that the firm does not consider compliance a priority, that the firm does not deliver on its commitments generally, and/or that the firm is disorganized and does not remember commitments that it makes.
 - g. Repeated failures to correct adequately a cited deficiency can lead to an enforcement action, even where the conduct did not lead to any identifiable harm to clients.¹¹

¹⁰ 18 U.S.C. § 1001 (2006).

¹¹ Indeed a failure to correct prior deficiencies led to the first enforcement action under Advisers Act Compliance Rule, Rule 206(4)-7. *See* CapitalWorks Inv. Partners, LLC and Mark J. Correnti, Inv. Advisers Act Release 2520, 2006 SEC LEXIS 1306 (June 6, 2006). *See also*, for example, Gofen and Glossberg, Inc., Advisers Act Release No. 1400, 1994 SEC LEXIS 99 (Jan. 11, 1994) (custody violations); Howard M. Borris & Co., Inc., Advisers Act Release No. 1460, 1995 SEC LEXIS 31 (Jan. 9, 1995) (books and records, custody and reporting violations); Louis E. Sharp, Admin. Proc. No. 3-8590, 1995 SEC LEXIS 35 (Jan. 11, 1995) (books and records, reporting and cash solicitation rule violations); and Stephen C. Schulmerich, et al., Advisers Act Release No. 1358, 1993 SEC LEXIS 22 (Jan. 4, 1993) (books and records and reporting violations).

- h. Maintaining Confidentiality. Information that the firm produces in the context of an SEC inspection is likely to include confidential business information, such as client names, strategies, product information and compensation information.
 - (i) The information can be subject to disclosure to numerous sources, including competitors and the press, pursuant to Freedom of Information Act (FOIA) requests. It is therefore essential for the firm to take precautions to minimize the likelihood of any such disclosures.
 - (ii) The firm can request confidential treatment under FOIA. The SEC has established procedures for requests for confidential treatment which generally afford the party who produced the documents to object to their disclosure if they are requested pursuant to FOIA.¹²
 - (iii) The firm also can request, preferably in writing, that produced documents be returned. Although the SEC retains some documents that are produced during an inspection, it frequently does not need to keep all of them.

E. Meeting the SEC Staff's Highest Expectations

- 1. In recent examination information request lists, the SEC staff has asked for information that goes far beyond the records required by specific rules. In particular, the staff has asked for documentation of the adviser's risk identification and assessment process, and it has insisted that the firm demonstrate how the firm's compliance procedures are applied in practice and how effective they are at preventing, detecting and correcting compliance problems. The latter request has come to be summarized as the staff's insistence on "outputs" of the compliance process.
- 2. While these requests are challenging, they also present an opportunity for the compliance-oriented adviser to demonstrate proactively to OCIE staff the strength of the adviser's compliance program.
- 3. Risk Assessments and Compliance Reviews.
 - a. The staff typically requests many or all of the following:
 - (i) A copy of the firm's "standard operating procedures" ("SOP") for the risk identification and assessment process;
 - (ii) A copy of the minutes of any risk committee meetings (noting that risk committees are not required);

¹² Confidential Treatment Procedures under the Freedom of Information Act, 17 C.F.R. § 200.83 (2006).

- (iii) A current inventory of compliance risks;
 - (iv) The SOP used to create and maintain the firm's compliance policies and procedures;
 - (v) A document, *e.g.*, a matrix or spreadsheet, mapping its inventory of risks to its written policies and procedures; and
 - (vi) A copy of all annual and interim reports on reviews of the firm's compliance program.
- b. While the majority of these documents are not required, they outline a process towards approaching risk that they SEC staff favors. The greater the extent that an adviser incorporates elements of this approach into its own processes, the easier it will be for that firm to convince OCIE that it has a high-quality and low-risk compliance program.
- c. The core of the SEC's preferred approach is a periodic and ongoing risk assessment process. Outputs like risk matrices, committee meeting minutes, and interim and annual reports can be used to document this process. In fact, the risk matrix has become essentially a standard part of the compliance and risk process, and thus each firm should maintain and update a well-organized risk matrix. At its heart, risk assessment requires the adviser to identify and prioritize issues, conflicts and other matters regarding the adviser's operations that may create risks to the adviser and its clients. The risk assessment may be performed by the CCO, the compliance or risk department, special committees or third parties.
- d. Risk reviews should consider, among other things, the effectiveness of the existing control procedures, frequency of supervisory reviews and whether escalation procedures exist for exception reports. The review should consider past SEC deficiency letters (if any) and material and non-material compliance matters that have arisen.
- e. Risks may include operational risk (inadequate information/operational systems), strategic risk (inadequate prospective business decisions), financial risk (that the adviser may be unable to meet its financial obligations) and compliance risks (inadequate resources for compliance or inability to address conflicts of interest).
- f. Risk reviews may be conducted throughout the year, quarterly or annually in connection with the annual review required by the compliance rule. Risk assessments should be conducted whenever

the adviser enters a new line of business or offers new products or services. In addition, new guidance from the SEC will be useful in determining whether special areas should receive additional scrutiny.

4. The Annual Review and Risk Evaluation

- a. Rule 206(4)-7 specifically requires advisers to annually review their policies and procedures for adequacy and effectiveness. The review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise compliance policies and procedures. The adopting release for the Rule points out that, although the Rule only requires an annual review, interim reviews may be necessary in response to significant compliance events, changes in business arrangements, and regulatory developments. OCIE staff has clear expectations that annual and interim reviews will be incorporated into the firm's ongoing risk identification and assessment process.
- b. The Rule does not mandate a written report, although SEC examiners will likely be seeking written materials documenting the annual report in connection with inspections. If written materials are prepared, areas that may be covered (but not required), include: management cooperation, risk assessment methods, analysis and conclusions, industry best practices, back testing results, violations, remedial actions, prior concerns, compliance certifications, compliance personnel assessment, self evaluations, compliance budget, resources, staffing, training and education, changes/updates to the compliance program, overall assessments, and goals for the coming year.
- c. While the adviser has flexibility to determine the specific details of an annual review, the goal is to discover if the compliance program is working properly to prevent, detect, and correct compliance issues.
- d. The annual review of registered investment company policies and procedures requires the submission by the CCO of a written report to the fund's board under Rule 38a-1. The CCO's annual report is required to include information about the operation of the policies and procedures of the fund and its principal service providers, material changes made to those policies and procedures since the date of the last report, material changes to the policies and procedures recommended as a result of the annual review, and

“Material Compliance Matters” that occurred since the date of the last report.

- e. The SEC staff, as part of a routine inspection, will examine the firm’s compliance review to determine if the firm’s compliance program continues to reasonably and effectively prevent compliance issues from happening, detect those compliance issues that do happen and promote the prompt correction of the issues that occur.” Speeches by SEC staff members outline several questions the inspections staff will be asking concerning compliance reviews and compliance programs. The issues are summarized below:
- (i) Who conducted the annual review? (e.g., the CCO, with other compliance staff, with business-line staff, internal auditors, external counsel or compliance consultant)
 - (ii) What was the scope of the review, and how was the scope determined (i.e., was a risk-assessment completed, did the scope include existing compliance policies and procedures, did it review the firm’s process for identifying gaps)
 - (iii) When was it performed?
 - (iv) How was it performed? (e.g., using a checklist, forensic tests, review of past exceptions)
 - (v) What were the findings? (we would expect that thorough reviews would be likely to have findings and/or areas where the firm’s compliance programs could be proactively improved)
 - (vi) What recommendations were made by the staff who conducted the review? (do they appear to adequately address the findings)
 - (vii) What is the current status of those recommendations -- have they been implemented?
 - (viii) What documentation was created and retained by the firm to reflect the work done?
 - (ix) What, if any, was the involvement of senior management in the review?

Speech by Lori A. Richards, Director, Office of Compliance Inspections and Examinations, December 5, 2006

F. Demonstrating "Outputs": Compliance Testing

1. The SEC staff has been placing greater emphasis on "documents that contain 'output' from the application of compliance policies and procedures." "Output" can include a wide variety of types of documents, including the risk and compliance matrices and annual and interim reports noted above. But these documents are at their core summaries of what OCIE considers to be the most critical part of a compliance program: review and testing of compliance procedures to determine how effective they are in preventing, detecting and correcting compliance problems. OCIE has outlined three types of testing that they expect to see: transactional testing, periodic testing, and forensic testing.
2. Much of what an adviser's compliance staff does in its day-to-day activities amounts to informal review and testing. The key to demonstrating "outputs" to the SEC staff involves systematically documenting these activities. Indeed, the compliance staff should approach their daily jobs with the understanding that one of their critical tasks is to document "outputs" of the firm's compliance program. If compliance is viewed this way, it will save the firm resources as well as work during the annual review.
3. *Transactional testing.* Transactional testing is performed at or around the time an activity occurs.
 - a. For example, when an investment is made for a client account, a transactional test would be performed around the time the investment is made. Many firms have automated this process through trade order management systems that have investment parameters programmed for each account. Typically, the system kicks out a daily "exception report." To document a transactional test, a compliance officer could tick off each item and sign off on the report. If the process is not automated, the firm should standardize and preserve the workpapers the compliance personnel use to test each transaction for compliance with portfolio restrictions.
 - b. Similarly, transactional trading tests are performed at the time each trade occurs, *e.g.*, to ensure that a trade is performed only with approved counterparties at approved rates. "Outputs" could be documented in the same way as for portfolio compliance tests.
 - c. Transactional tests of a code of ethics involve review of a personal trade or a request for preclearance for a personal trade. The SEC staff views compliance with an adviser's code of ethics as a bellwether of the firm's compliance culture. Thus, special care

should be taken to document reviews that each employee's trades (or a meaningful sample thereof) comply with the firm's code.

4. *Periodic testing.* Periodic testing is performed at appropriate intervals, but not contemporaneously with each transaction. Certain areas cannot be practically tested throughout the day as transactions occur, but should be reviewed at appropriate intervals.
 - a. For example, client contracts and client statements of investment objectives could be periodically reviewed, and the clients' portfolios and investment performance could be periodically analyzed to assure compliance with the clients' mandates.
 - b. Similarly, the completeness and accuracy of records could be reviewed periodically.
5. *Forensic testing.* Forensic testing is focused on evaluating whether the outcomes of operational and investment activities over time are consistent with expectations. Forensic tests serve the purpose of critically testing an activity to determine whether there is a suspicion that the compliance system is being subverted through some clever means that may be difficult to detect through the other forms of testing. As noted by staff of the SEC: "An essential aspect of the firm's compliance program is the application of forensic tests in critical areas that may harbor possible illegal acts, schemes and arrangements." For example, a review of the performance of similarly-managed client accounts may be able to detect whether one client is favored over another in the allocation of trades or investment opportunities. The statistically formalized version of this test is called "dispersion testing" in that it tries to detect unwarranted variation or dispersion in client results.
6. A simple example can illustrate the differences between the three tests. If tests are developed to ensure that investments for client accounts conform to client-imposed restrictions, all three types of tests can be used. A transactional test would compare a purchase with the investment guidelines. A forensic test would compare the performance of the account with the performance of a relevant benchmark and other client accounts with similar guidelines, the expectation being that material differences in performance would suggest that client guidelines are not being followed. A periodic test would involve a review of documents reflecting client imposed investment guidelines and a comparison of those guidelines with the list that is used for transactional testing of each purchase.





UNITED STATES SECURITIES AND EXCHANGE COMMISSION
INFORMATION REQUEST LIST

MASTER INFORMATION REQUEST LIST (for non-sweep exams) –

INVESTMENT ADVISERS

JANUARY 2007

[NOTE TO EXAMINERS: *This request list is intended to represent a rather comprehensive compilation of potential requests for investment adviser examinations. Examiners should determine, based on the nature of the firm and the scope of the examination, which items should actually be requested from the firm being examined.*

You may need to request information from registrants that is not included in any of these request lists, either at the beginning of an inspection or at a later time, depending on facts and circumstances, specific areas of focus, detailed information listed in an inspection guide that is being used during an inspection and the need to perform forensic analyses to obtain corroborating evidence for preliminary findings in areas of concern to the exam team.]

Registrants:

Please furnish the information listed below for the above-referenced entity. Please also use your judgment regarding whether records requested in both electronic format and hard copy should only be provided electronically. Where necessary, furnish responses on Registrant's letterhead. Unless otherwise indicated, please provide the requested information for the time period of DATE to DATE (the "inspection period"). Please note that this inspection period is subject to change at any time without written notice. This request for information is divided into two main parts. The first part, which covers all items listed in Sections A and B, identifies information that is to be provided at the outset of the inspection. The second part, which includes all items in Section C, lists information that may be requested if Registrant's compliance program is deemed to be weak or if other information we review indicates to us that additional scrutiny of any area is necessary.

At this time, copies need not be made of information in any of the sections to which only access is requested. However, please have such information *collected and ready* for the staff's review. While certain information is specifically identified in this document, during the inspection the staff may request additional information if it becomes necessary.

At the commencement of our fieldwork, we would like to speak with at least one member of senior management to obtain an overall view of Registrant's organization, business, control environment, and compliance culture. Also during our fieldwork, we would like to discuss in more detail with the Chief Compliance Officer and Risk Manager (if Registrant has such a position), and other persons as relevant, Registrant's compliance program, as well as the specific compliance risks Registrant has identified and the policies and procedures used to mitigate and manage such risks in the areas listed in Section A. At various times during our fieldwork, we will also want to interview persons responsible for functions such as portfolio management, trade execution, pricing, back office/administration, information technology, anti-money laundering, and marketing.

A. Risk Management and Internal Controls

Rule 206(4)-7 under the Investment Adviser's Act (compliance date October 5, 2004) is designed to protect investors by ensuring that all advisers have internal programs to enhance compliance with the federal securities laws. To assist us in evaluating Registrant's compliance program, please provide relevant information that documents and substantiates the effectiveness of Registrant's compliance policies and

Master Information Request List – Investment Advisers

procedures in each of the areas identified below. In addition to policies, procedures, and compliance manuals, please make available documents such as: exception reports together with documentation of follow-up work, completed compliance checklists, reconciliations, management reports, documents containing supervisory approval of overrides in various areas, warning or sanction notices to staff that violated a policy or procedure, results of and related analyses of transactional (quality control) and forensic testing, follow-up work performed based upon such analyses, self-assessments of the effectiveness of Registrant's compliance policies and procedures, internal audit reports, and so on.

NOTE: In responding to our requests for information below, you should provide information that demonstrates how the policies and procedures used by Registrant to mitigate and manage its compliance risks are applied in practice. In this regard, procedures and compliance manuals represent a useful starting point; these manuals do not, however, provide information about how compliance policies and procedures are being applied in practice or how effective such policies and procedures may be in preventing, detecting and correcting compliance problems. As a result, you can demonstrate the effectiveness of your compliance processes only by providing documents that contain "output" from the application of such compliance policies and procedures to the daily work flows of Registrant.

Failure to provide information that documents how your compliance program operates in practice may result in our concluding that Registrant has weak or ineffective risk management and control processes and is not in compliance with Rule 206(4)-7.

- A1. Registrant's overall process for and commitment to establishing and maintaining an effective compliance culture (its "tone at the top").
- A2. The specific compliance policies, techniques and procedures used in achieving the following important objectives:
 - a. Portfolio management decisions are consistent with clients' mandates (investment objectives, restrictions and risk tolerance), regulatory requirements, disclosures and fiduciary obligations.
 - b. Decisions made and costs incurred in establishing and maintaining Registrant's brokerage arrangements and placing orders (trades) for clients are consistent with maximizing the value of clients' accounts, disclosures made to clients, regulatory requirements and fiduciary obligations.
 - c. Allocations among clients' accounts of IPOs, other investment opportunities, and blocked and crossed trades in issues traded on secondary markets are fair and consistent with disclosures, regulatory requirements and fiduciary obligations.
 - d. Prices used to value positions in clients' accounts, including all clients that are commingled accounts/funds, reflect accurately current market conditions and the prices that could be realized upon a current sale of those positions; the process used to calculate NAVs of commingled accounts/funds results in consistently accurate allocations of the commingled accounts' net assets among participants/fund shareholders and is consistent with disclosures and regulatory requirements.
 - e. Advisory clients' assets, including those of commingled accounts/funds, are held and moved in ways that protect them from theft, misappropriation, misuse, and loss.
 - f. Information provided to advisory clients and commingled account/fund shareholders regarding transactions in and balances of their accounts reflects accurately the actual transactions in and balances of those accounts and reflects fairly all decisions affecting these accounts.
 - g. Personal trading activities of access persons and investment decisions for proprietary accounts

Master Information Request List – Investment Advisers

of Registrant are consistent with codes of ethics, regulatory requirements, disclosures and fiduciary obligations.

- h. Performance and other information used in advertisements and other marketing materials is calculated accurately and fairly and is used in ways that are not misleading and marketing and distribution activities are consistent with regulatory requirements and disclosures.
- i. Information about Registrant's operations and activity in client accounts is timely and accurately created, captured, and compiled, and is safeguarded from unauthorized access, use, manipulation, alteration, and untimely destruction; such information is used to provide complete, accurate and timely reports and statements to management, clients, and regulators.
- j. Registrant's compliance program is adequately designed and maintained so as to prevent, find and resolve violations of relevant statutes, rules and other regulatory guidance.
- k. Anti-money laundering programs effectively prevent Registrant from being a party to money laundering or terrorist financing schemes.

A3. Provide the following documents pertaining to Registrant's compliance program:

- a. A copy of the standard operating procedures ("SOP") for the risk identification and assessment process, which is the process by which Registrant identifies risks and problems likely to be present at the adviser.
- b. A copy of the minutes of any risk committee meetings that were held during the inspection period. Please note that advisers are not required to have a risk committee.
- c. A current inventory of compliance risks. If changes were made to this inventory of risks during the inspection period, please indicate what these changes were and the corresponding date of the change. Please provide this information, if possible, in Word, Excel or the equivalent format on 3.5-inch diskettes or CD-ROM/DVD.
- d. A current list of and a corresponding copy of all compliance policies and procedures. (*You do not need to provide a copy if you intend to provide one in response to another item, please just reference the appropriate response*). In addition to providing a list of the compliance policies and procedures, please also provide a list of corresponding compliance documents. These compliance documents may include exception reports, compliance check lists, management reports, etc. that are produced in accordance with the compliance policies and procedures. Please provide this information, if possible, in Excel format on 3.5-inch diskettes or CD-ROM/DVD.
- e. The SOP covering the process used to create and maintain the compliance policies and procedures mentioned above.
- f. Any document Registrant has, such as a matrix or a spreadsheet, that maps its inventory of risks identified above to its written policies and procedures.
- g. Information regarding the means by which Registrant's personnel have ready and continuing access to these policies and procedures.
- h. If Registrant performed any forensic tests (i.e. compliance tests that analyze information over time in order to identify unusual patterns) during the inspection period, perhaps as a component of its annual review of its compliance program, provide a list of the forensic tests performed, and the corresponding objectives and results of each forensic test.
- i. A copy of all annual and interim reports regarding the review of Registrant's compliance program.

Master Information Request List – Investment Advisers

- j. A copy of any SOP that governs the process used by Registrant to conduct the annual review of its compliance program and related report preparation.
- k. Access to workpapers that were prepared during Registrant's reviews of its compliance program.
- l. Access to reports, summaries and other information a fund received from or pertains to compliance programs and activities of the fund's service providers.
- m. Access to Registrant's budgets or financial plans for compliance activities during the inspection period.

B. Initial Requests for Information

Compliance Rule/Internal Controls

- B1. Provide complete information about all undisclosed arrangements or side arrangements that adversely impact advisory clients and directly or indirectly benefit any person or entity other than advisory clients.
- B2. A copy of any report or letter submitted to management by Registrant's independent auditors concerning internal controls (including any report or letter to the board of directors of any affiliated fund group).

General Information

- B3. Registrant's organization chart, employee list and a schedule or chart of all affiliated entities. Please include all advisory representatives and/or independent contractors.
- B4. (i) A list of current clients (excluding wrap fee clients) featuring for each:
 - a. Account number, account name and the current balance;
 - b. Whether the client is a related person or a proprietary account;
 - c. Account custodian, including name and location;
 - d. Type of account (e.g., individual, family office, defined benefit retirement plan, registered fund, private investment fund, other unregistered fund);
 - e. Investment strategy (e.g., global equity, high-yield, aggressive growth, long-short, statistical arbitrage);
 - f. Whether or not Registrant has discretionary authority;
 - g. Whether client has a directed brokerage arrangement (include name of broker and purpose for such direction, if known);
 - h. Value of each client's account at end of period that was used for purposes of calculating its advisory fee for the most recent billing period;
 - i. Whether the client pays a performance fee;
 - j. Whether the client receives account statements directly from the custodian.

Master Information Request List – Investment Advisers

(ii) A list of wrap fee (SMA) programs in which one or more clients participate, including for each program:

- a. Name of custodian/sponsor/broker-dealer;
- b. Total fee percentage charged by the sponsor;
- c. Terms of Registrant's compensation;
- d. Total value of client assets in each program as of the most recent billing date.

(iii) The total value of assets under management for *all clients* combined.

Please provide this record electronically, preferably formatted in Microsoft Excel as indicated in Exhibit 2, attached.

- B5. A list of clients obtained during the inspection period, their account inception dates, and the identity of any third party consultant instrumental in Registrant's obtaining a particular client. Please provide this record both on a hard copy and in electronic format.
- B6. A list of clients lost during the inspection period, their effective dates of termination, the asset value at termination, and the reason for termination. Please provide this record both on a hard copy and in electronic format.
- B7. A list of officers or directors who either resigned or were terminated during the period with an explanation regarding the reason for their departure.
- B8. A list of employees who were terminated during the period with an explanation regarding the reason for their departure.
- B9. A list of threatened, pending and settled litigation or arbitration to which Registrant was a party during the inspection period. Provide a description of the allegations forming the basis for each issue, the status of each pending issue, and a brief description of any "out of court" or informal settlement. If none, please provide a written statement to that effect.
- B10. Access to all advisory client and hedge fund investor complaints received during the inspection period and information regarding how each complaint was resolved. Such information could be a copy of any communications sent to the complainant.
- B11. Any no-action letters or exemptive orders relied upon by Registrant.
- B12. Access to any correspondence with the staff of the Commission or other regulatory agencies.

Portfolio Management

- B13. Registrant's trading blotter or purchase and sales journal for the inspection period, preferably formatted in Microsoft Excel as indicated in Exhibit 1, attached. Please also include the transactions of Registrant's access persons and proprietary accounts in this record.
- B14. An electronically formatted cross reference, stock record, or securities position record of all client securities holdings, by client as of DATE. This list should show the name of each security, the number of shares or principal amount held, and the market value of the security position.
- B15. An electronically formatted record of all securities held in all client portfolios (aggregate position

Master Information Request List – Investment Advisers

totals for all securities), as required by Rule 204-2(c)(1)(ii), as of DATE. This list should show the name of each security, the aggregate number of shares or principal amount held, and total market value of the security position. In addition, the record should list the name of each client who holds an interest in the security and the amount owned by such client.

- B16. For each investment strategy in which Registrant managed assets during the inspection period, provide annualized performance returns from DATE to DATE. Also include non-annualized quarterly performance returns for each quarter from DATE to DATE. If possible, please provide this information electronically.
- B17. Access to any risk management reports that show/illustrate the measures used to manage risks in client accounts, such as leverage, beta, concentration, and performance attributions analysis.
- B18. With respect to proxy voting, please provide the following:
- a. A copy of Registrant's proxy voting policies and procedures;
 - b. List of accounts for which Registrant votes proxies;
 - c. Documentation that Registrant has described its proxy voting procedures to its clients and provides copies of such disclosures upon request;
 - d. Disclosure provided to clients regarding how they may obtain information on how Registrant voted their proxies;
 - e. A copy of each written client request for information on Registrant's proxy voting, and a copy of any response to any request (written or oral); and
 - f. A copy of any document created by Registrant that was material to making a voting decision, or that memorializes the basis for that decision.
- B19. A list of publicly traded companies of which officers of Registrant, or affiliates of Registrant, serve as officers or directors.
- B20. On a total return basis, provide a list of Registrants' 10 most profitable positions that were opened and closed during the inspection period.

Information Processing and Protection

- B21. Access to policies and procedures adopted to comply with Regulation S-P, including any written policies and procedures addressing administrative, technical, and physical safeguards for the protection of customer records and information ("information security") under Regulation S-P. Please have available:
- a. Each form of privacy notice (initial, simplified, short-form initial, revised, and annual) sent to consumers and customers;
 - b. Each form of an opt-out request notice sent to consumers and customers (if not contained in the privacy notice);
 - c. Any complaints or inquires received regarding privacy or information security issues;
 - d. Records of internal investigations and dispositions regarding privacy or information security issues;
 - e. Records of vendor software patch implementations; and

Master Information Request List – Investment Advisers

- f Intrusion detection logs and records documenting how Registrant addressed the matter.
- B22. Access to written plans, policies, and procedures that provide guidance in preparing for and responding to emergencies, contingencies, and disasters.
- B23. Documentation regarding the results of Registrant's most recent test of its business continuity plan.

Personal Trading

- B24. A copy of Registrant's Code of Ethics and insider trading policies and those of participating affiliates, and a list of all access persons, including contract employees, required to report transactions.
- B25. Policies and procedures adopted, if not incorporated in Registrant's Code of Ethics, to address employee personal trading hardship exemptions from Registrant's personal trading policies.
- B26. Policies and procedures adopted, if not incorporated in Registrant's Code of Ethics, to govern the personal trading of contract employees.
- B27. If separate from Registrant's Code of Ethics, a copy of its policy governing receipt by officers and employees of gifts and entertainment.
- B28. Provide access to any file or log maintained of gifts and entertainment received by Registrant's directors, officers and employees. Note that Registrant is not explicitly required to maintain any such log or file.
- B29. Records of violations of the Code of Ethics during the inspection period.
- B30. Provide access to the files or database that contains "holdings" information reported by access persons under Registrant's Code of Ethics.

Brokerage Arrangements and Execution

- B31. List of affiliated broker-dealers featuring their affiliation and a description of their clearing arrangements.
- B32. A list of all employees or their relatives who are principals or registered representatives of a broker-dealer.
- B33. A list of the soft-dollar arrangements, both third-party and proprietary, to which Registrant was a party during the inspection period. This list should be provided in Excel format and should include the following information for each arrangement:
 - a. The name of the broker or other entity involved in each arrangement;
 - b. The nature of the goods or services received by Registrant under the arrangement;
 - c. Whether the goods or services are third-party or proprietary or both;
 - d. A detailed description of how the product or service is used by Registrant;
 - e. The approximate annual amount of commissions on securities transactions needed to satisfy each arrangement;
 - f. The soft-dollar ratio with respect to each arrangement;

Master Information Request List -- Investment Advisers

- g. Whether the product or service received is within the Section 28(e) safe harbor;
 - h. The allocation procedures used if this item is considered to be mixed use;
 - i. The total brokerage commissions used to obtain each product or service for the current year to date and the previous year;
 - j. The types of transactions used to generate soft dollars for this agreement (i.e. equity or fixed income, listed or OTC, agency or principal, or new issue designations);
 - k. The current amount of soft dollar credits generated by securities transactions placed by the adviser for the current year to date and the previous year;
 - l. Whether or not invoices or statements which record soft and/or hard dollars paid are sent to Registrant and, if so, how often;
 - m. A copy of any written agreement; and
 - n. Whether the broker-dealer providing the product or service is contractually obligated to pay the cost of the product or service.
- B34. A list of trading errors (e.g., bought rather than sold, entered limit order at wrong price, entered for wrong account, etc.) that occurred in client or proprietary accounts during the inspection period featuring the transaction date, the security, the account and broker-dealer involved, and a summary of the error and its ultimate disposition, including the conditions of any financial settlement.
- B35. List of approved broker-dealers currently in use by Registrant's trading staff.
- B36. A list of cross transactions which took place during the inspection period in which any client was a participant. These transactions would include those where a broker was used or where Registrant, acting without a broker, effected the transactions.
- B37. A list of securities which Registrant or any affiliate underwrote or with respect to which Registrant participated in such securities' underwriting as underwriting manager or member of a purchase group (or syndicate) or selling group during the inspection period and which were purchased by or for any client. For each situation identified provide the approximate date of the underwriting.
- B38. List of securities for which Registrant or an affiliate was a market maker during the inspection period.
- B39. A list of broker-dealers with whom Registrant has or had revenue sharing agreements for any purpose during the inspection period.

Trade Allocations

- B40. A list of all initial public offerings during the inspection period in which Registrant's clients (including registered and unregistered funds), proprietary accounts or its access persons participated (i.e., purchased shares). Indicate whether such shares traded at a premium over the public offering price when trading in secondary markets began ("hot issues"). Please include the security name, symbol, total number of shares, and the clients involved in the transactions.
- B41. Any written trade allocation policies and procedures, if not provided in response to another item.

Performance Advertising and Marketing

- B42. A list of all parties to whom cash referral fees were paid during the inspection period for soliciting

Master Information Request List – Investment Advisers

clients and the total compensation paid to each solicitor for the periods ending **DATE, DATE, and DATE**. In addition, copies of any agreements executed with any third party solicitors, any correspondence with such solicitors, and any separate disclosure documents disseminated by such solicitors.

- B43. A list of all third-party consultants for whom Registrant completed questionnaires or otherwise corresponded with during the period.
- B44. A list of all third-party consultants (such as pension consultants) to whose clients Registrant made a presentation in an effort to obtain or retain such entity as an advisory client.
- B45. A list of all third-party consultants from whom Registrant or any of its affiliates purchased any product or service (including any payments connected to conferences sponsored or hosted by the consultant) during the inspection period.
- B46. A copy of the most recent RFP (Request-for-Proposal) completed during the inspection period.
- B47. A list of all conferences sponsored or held by Registrant, the respective dates thereof, and the names of all attendees and the companies who employ them.
- B48. A copy of all advertisements (e.g., newspaper or magazine ads, radio scripts, reprints, etc.) used to inform or solicit clients during the inspection period. If Registrant makes information about its services available on the Internet, including websites and blogs, please include a printout.
- B49. If Registrant's website includes sections for clients or advisory representatives that are accessible only with a username and password, please establish a temporary username and password for the examination staff's use during this inspection and provide such passwords in your response.
- B50. A copy of any promotional brochures, pamphlets or other materials furnished to existing and/or prospective clients during the inspection period.
- B51. A copy of any composite or representative performance reports, data or graphs disseminated to clients or prospective clients during the period.

Information Disclosures, Reporting, and Filings

- B52. Registrant's current standard client advisory contract or agreement.
- B53. Any sub-advisory agreements executed with other investment advisers.
- B54. Registrant's fee schedule(s) currently in use, if not stated in the advisory contracts.
- B55. Copy of powers of attorney or discretionary authority Registrant obtains from clients if not incorporated directly in the advisory contracts.
- B56. Form ADV Part II currently furnished to clients and any alternative disclosure document given in conjunction with or in lieu of Part II. In addition, please include a copy of Registrant's Form ADV Part IA.
- B57. Registrant's balance sheet, trial balance, income statement, cash receipts and disbursements journal, and cash flow statements dated as of the end of its most recent fiscal year and the most current year-to-date.

Master Information Request List – Investment Advisers

Safety of Clients' Funds and Assets

- B58. If Registrant has physical custody or possession of any client funds or securities, so state, and provide a list of the clients for whom Registrant has such custody or possession.
- B59. If Registrant or its related persons is deemed to have custody or possession of or access to any client funds or securities, please provide:
- a. A list including the names of all affected clients;
 - b. The current market value of all assets in possession or to which access is available;
 - c. The locations where such assets are held or the names of the custodians holding them;
 - d. Whether these clients receive account statements from the custodian or Registrant; and
 - e. The name of any independent representative designated by the client to receive these statements.
- B60. List of clients for whom Registrant, an officer, or an affiliate acts as trustee, co-trustee, or successor trustee or has full power of attorney for the account.

Pricing of Clients' Portfolios

- B61. A list of pricing services, quotation services, and externally acquired portfolio accounting systems utilized by Registrant, including a description of whether such items were paid for with hard-dollars, soft-dollars, or a combination thereof.
- B62. A list of all securities that have been fair valued or priced by Registrant.

Anti-Money Laundering

- B63. A copy of any anti-money laundering policies and procedures adopted.
- B64. Documentation of any annual review conducted of Registrant's anti-money laundering policies and procedures.

Compliance Rule

- B65. Any regulatory compliance manual not already provided in response to a previous item.

For Advisers with Clients that are Pooled Investment Vehicles

This section encompasses all investment funds advised by Registrant or an affiliate which are not registered under the Investment Company Act of 1940 (typically referred to as a "private investment fund").

- B66. A list of private investment funds featuring for each:
- a. Name as shown in organizational documents (as amended);
 - b. Domicile (country);
 - c. The investment strategy (long-short, statistical arbitrage, fund of funds);
 - d. If fund is a master fund, full name and domicile of each feeder fund as of DATE;
 - e. If fund is a feeder fund, full name and domicile of master fund;

Master Information Request List – Investment Advisers

- f. The number of investors and total assets at the end of inspection period;
- g. The amount, if any, of Registrant's equity interest in each fund as of **DATE**;
- h. The amount, if any, of Registrant's affiliated persons' equity interest as of **DATE**;
- i. The date the fund began accepting unaffiliated investors;
- j. Whether the fund is currently closed to new investors;
- k. Lock-up periods for both initial and subsequent investments;
- l. The specific exemption(s) from registration upon which each fund relies (e.g., Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act);
- m. The services Registrant or an affiliate is providing (e.g., general partner, adviser, managing member); and
- n. The amount of leverage, both explicit (on-balance sheet) and off-balance sheet (futures and certain other derivatives), used by the fund as of **DATE** as measured by Registrant for risk-management purposes.

B67. For each private fund, as defined in Rule 203(b)(3)-1(d), please provide copies of the following:

- a. The current version of the fund's offering document or private placement memorandum;
- b. The organizational document and operating agreement (e.g., partnership agreement);
- c. The financials, audited or un-audited, for its **two most recent fiscal year ends**;
- d. The general ledger, separated by calendar year, underlying the above-referenced statements;
- e. The organizational chart of the general partner/managing member;
- f. Account statements sent to investors during the current fiscal year, if any;
- g. A list of current investors including total current value of each investor's equity interest in the fund;
- h. A list of investors who purchased and redeemed an interest in the fund during the inspection period, including for each the cost of the interest and whether it was a purchase or redemption;
- i. Latest advisory fee calculation, including any performance fee calculations, and the specific manner in which the fees were calculated;
- j. A list of illiquid securities and/or private placements, as defined by Registrant, as of **DATE**;
- k. A complete description of all positions held in side pockets or special situation accounts together with their valuation on the date of the related calculation of net asset values; and
- l. A description of all business activities of the registered adviser(s) affiliated with each fund that are not covered by the required compliance programs of such advisers and oversight by their chief compliance officers (examples of such activities may include calculation of net asset values, preparation of financial statements and calculation of limited partner interests in the fund).

Master Information Request List – Investment Advisers

- B68. Please request the custodian(s) of each private fund to provide a confirmation of all positions, including all cash balances and short positions, as well as any loans or other creditor positions it has outstanding with the fund. This information should be provided as of DATE for each fund. In addition, the position list should be signed by an officer of the custodian and sent directly to:

Securities and Exchange Commission
Attention: Examiner Name
Street Address
City, State, Zip

- B69. If an entity other than the fund's adviser maintains records regarding the interests of each fund investor in the fund, please request that entity to provide a confirmation of the following, as of DATE:

- a. the total number of shares outstanding if fund is in corporate form;
- b. the total number of limited partners; and
- c. the most recently calculated value of each limited partner's interest in the fund.

This information should be signed by an officer of the Administrator and sent directly to:

Securities and Exchange Commission
Attention: Examiner Name
Street Address
City, State, Zip

Please provide the staff a copy of each request.

C. Secondary Requests for Information

Based on our discussions with Registrant's staff, our review and analysis of the items requested above, and our evaluation of the effectiveness of Registrant's compliance processes for the areas identified in Section A., we may ask for additional books and records regarding specific activities. Below is a list of information that should be readily available if a request is made by the examiners.

General Information

- C1. A list of any joint ventures or any other businesses in which Registrant or any officer, director, portfolio manager or trader participates or has any interest (other than their employment with Registrant), including a description of each relationship.
- C2. For individuals to be selected by the staff upon commencement of the examination, or shortly thereafter, please be prepared to provide all e-mails, including their corresponding attachments, sent and received during a period to be specified. This information should be provided in an electronically searchable format. In identifying e-mails that are responsive to our needs, please be mindful that e-mails may be stored both on servers and on individual hard drives of the persons selected. These emails may also be maintained by third parties such as AOL, Microsoft or Bloomberg.
- C3. For each wrap fee arrangement in which Registrant's clients participate, a list, by sponsor, of the current and former clients who participate or have participated in the arrangement, including the client's name, the asset value of the account, and the investment strategy.

Master Information Request List – Investment Advisers

- C4. During the examination, the examiners will review Registrant's records pertaining to certain clients. Be prepared to furnish the following records for review for each client indicated:
- a. Advisory contract;
 - b. Custodial or trust agreement;
 - c. New account information forms, if applicable;
 - d. Client correspondence;
 - e. Documentation of annual offer pursuant to Rule 204-3 under the Investment Advisers Act of 1940;
 - f. Fee invoices for a period to be determined;
 - g. Custodial statements, and, if applicable, internally generated statements that correspond with the above-selected fee invoices;
 - h. Any reconciliations between the above-referenced statements;
 - i. Performance appraisals for a period to be determined;
 - j. For terminated clients, the date of termination, reason and, if applicable, evidence of refunded advisory fees where such fees are paid in advance; and
 - k. If applicable, notice of assignment of the client's advisory contract and their consent related to acquisition.

Portfolio Management

- C5. A list of all incentive and bonus programs offered by Registrant to its advisory representatives.
- C6. A copy of any securities lending procedures.
- C7. A list of all securities of clients that were loaned during the inspection period together with the net amount earned by each client for each security loaned.
- C8. A copy of the prospectus and statement of additional information for each mutual fund managed during the period.
- C9. A copy of any minutes from investment committee meetings.
- C10. A list of all derivative or synthetic products purchased or sold (written) for any clients during the inspection period.

Brokerage Arrangements and Execution

- C11. A copy of brokerage allocation reports for DATE, featuring the name of the firm, aggregate amount of agency commissions by the firm, and aggregate principal values or imputed compensation for principal transactions by the firm. Please provide this record in electronic format (preferably in Microsoft Excel format).
- C12. A list of all trades where Registrant had the executing broker "step-out" all or a portion of the entire transaction to another broker for settlement and confirmation, including the trade date, security, executing broker and confirming broker identities, the total number of shares filled by the executing broker, and the number of shares stepped-out by the broker.

Master Information Request List – Investment Advisers

- C13. Any written trading department policies and procedures, including order entry and execution allocation policies.
- C14. A list of all broker-dealers, including ECNs, affiliated or unaffiliated, that, to Registrant's knowledge, received order flow payments or rebates related to executing transactions for client portfolios.
- C15. A copy of any affiliated broker-dealer's trading blotter (purchase and sales journal) for the inspection period, which lists transactions in securities, and other financial instruments for clients, Registrant's proprietary accounts, and the affiliated broker-dealer's brokerage clients. For items p, q and r below, provide the names of the broker-dealers that shared in the compensation paid on the trade; also provide respective identifying numbers for each broker-dealer such as SEC registration number or CRD number. If possible, provide the following fields of data:

- | | |
|----------------------------------|---|
| a. Trade date | k. Number of shares or principal amount |
| b. Settlement date | l. Net amount to/from client |
| c. Post date | m. Ticker symbol |
| d. Buy or sell | n. Identifying number (SEDOL/CUSIP) |
| e. Security name | o. Client name |
| f. Fees | p. Name of executing broker-dealer |
| g. Accrued interest | q. Name of stepped in broker-dealer |
| h. Total commission | r. Name of introducing broker-dealer |
| i. Price | s. Client account number, and |
| j. Commission in cents per share | t. Market on which effected |

Exclude, if possible, from the above record any transactions in cash or cash equivalents, maturities, calls, pay-downs, expirations, or reinvestment of mutual fund dividends or capital gains distributions. Please provide this information in Excel format.

Trade Allocations

- C16. Performance returns for each client account for the 1-year period ended **DATE**.

Personal Trading

- C17. A record of all written acknowledgements as required by Rule 204A-1(a)(5) for each person who is, or was within the past five years, a supervised person of Registrant.
- C18. A record supporting the decisions to approve securities acquisitions by access persons under Rule 204A-1(c).
- C19. Access to records of employee personal securities transactions during the inspection period kept pursuant to Rule 204-2(a)(12) under the Investment Advisers Act of 1940.
- C20. Custodial statements for any proprietary/investment accounts of Registrant for the inspection period.

Performance Advertising and Marketing

- C21. A copy of any newsletters sent to clients during the inspection period.
- C22. A statement of the account inclusion criteria Registrant employs in the construction of any composite performance results.

Master Information Request List – Investment Advisers

- C23. A list of all composites that were terminated during the inspection period.
- C24. A list of any composites whose composition was changed on a retroactive basis. Please include the dates and reasons for the change.
- C25. The following records for each client account in an advertised performance composite:
- a. Internal calculations indicating beginning and ending asset values for each quarter, all capital additions and withdrawals (including the dates), and the quarterly performance return.
 - b. All custodial statements, including a statement that indicates the beginning asset value for the performance period. For example, the December 2003 statement for the verification of the calendar year 2004 performance returns.
- C26. Access to all questionnaires completed for third party consultants.

Information Disclosures, Reporting, and Filings

- C27. Registrant's revenue and expense journals and ledgers for the inspection period, including the following supporting records:
- a. Bank statements, canceled checks, deposit slips, and check registers for all bank accounts open during the period;
 - b. Loan agreements, notes payable, and notes receivable; and
 - c. Bills and statements, paid or unpaid, presented to or issued by Registrant.
- C28. A copy of Registrant's chart of accounts (with respect to expense journals & ledgers).
- C29. Access to Registrant's general ledger for a period to be determined.

Safety of Clients' Funds and Assets

- C30. Copies of any written policies and procedures that address the reconciling of client security holdings to outside custodian records.
- C31. For a sample of clients to be selected by the staff, please request the custodian to provide a copy of the most recent custodial statement as well as the mailing address(es) to which these statements are sent. This information should be sent directly to:

Securities and Exchange Commission
Attention: Examiner Name
Street Address
City, State, Zip

Please provide the staff with a copy of this request.

Pricing of Clients' Portfolios

- C32. To the extent Registrant has a valuation committee, copies of any minutes of the committee's meetings.

Master Information Request List – Investment Advisers

For Advisers with Pooled Investment Vehicles

Based upon discussions with Registrant's staff and review of the operations of Registrant's pooled investment vehicles, we may ask for the following additional information.

- C33. IRS Forms K-1.
- C34. IRS Forms 1065.
- C35. Fund custodial statements.
- C36. Fund bank account records, canceled checks, deposited items, etc.
- C37. Capital account transactions.
- C38. Rate of return calculations for the inspection period.
- C39. A copy of the documents that were used to calculate and which substantiate each of the net asset values that were used during the inspection period to price interests of purchasing and redeeming investors and/or for reporting to fund investors the value of their positions in the fund. At a minimum, the documents must show the date the net asset value was calculated and position level detail (both long and short), including a description of each separate asset and liability and descriptions and notional values of off balance sheet positions such as futures contracts.
- C40. Solicitation letters/advertising used during the inspection period.
- C41. List of cross transactions effected during the inspection period.
- C42. Fund administration agreements.
- C43. Valuations for illiquid securities and/or private placements held by the fund(s) during the inspection period.
- C44. Correspondence with investors, fund administrators, private placement investments, etc. during the inspection period.

For Advisers Managing Collateralized Bond or Debt Obligations

- C45. A list of all Collateralized Debt Obligations managed by Registrant during the period.
- C46. For each CBO or CDO that Registrant manages, provide copies of the following:
 - a. The collateral management agreement;
 - b. The offering document or circular;
 - c. The organizational document and operating agreement (e.g., trust indenture);
 - d. The financial statements for the **last two fiscal year-ends** and **DATE**;
 - e. The general ledger, separated by year, underlying the above-referenced statements;
 - f. All disclosure documents provided to clients who invested in the CDO; and
 - g. Sample of correspondence and reports sent to investors during the most current year.

Master Information Request List – Investment Advisers

- C47. For each CBO or CDO that Registrant manages, please indicate the name of the underwriter/sponsor.
- C48. Copies of any agreement with each underwriter/sponsor (other than those previously provided).
- C49. Access to all communications, including emails, between Registrant and sponsors of CDOs.
- C50. A list of Registrant's clients (former and current) who invested in CDOs managed by Registrant, indicating in which tranches or tiers the clients have invested.
- C51. For each client listed above please provide:
- a. Date and amount of investment;
 - b. Amount of investment;
 - c. Current value or liquidation value, if applicable;
 - d. Percentage of clients' portfolio that this investment represents; and
 - e. Copy of signed investment advisory agreement and subscription agreement.
- C52. Copies of promotional materials provided to prospective investors.
- C53. Please indicate the following:
- a. The specific exemption(s) from registration under Securities Act of 1933 and the Investment Company Act of 1940 upon which the CDO relies;
 - b. The services Registrant or an affiliate is providing (e.g., as sponsor, collateral manager, etc.);
 - c. The amount, if any, of Registrant's interest in the CDO as of DATE;
 - d. A list of investors obtained and lost during the inspection period;
 - e. The most recent collateral management fee calculation; and
 - f. If applicable, a statement showing the last two performance fee calculations and the specific manner in which the fees were calculated.
- C54. Copy of pricing procedures/methodologies used for the CDOs.
- C55. Access to pricing worksheets/calculations for the CDOs.

Exhibit 1

Layout for Securities Trading Blotter/Purchase and Sales Journal

In conjunction with the scheduled examination, the staff requests records for all purchases and sales of securities for portfolios of advisory clients and proprietary accounts being advised by Registrant. Please provide this record in Microsoft Excel format on either 3.5-inch diskettes or compact discs. This record should include the fields of information listed below in a similar format.

Please provide separate worksheets for (i) equities (Note: ETF trades should be included with equities), (ii) fixed income, (iii) cash or cash equivalents, maturities, calls, pay-downs, expirations, or reinvestments of mutual fund dividends or capital gains distributions, (iv) mutual funds, and (v) options, futures, swaps and other derivatives.

Examples:

A. Sample Trading Blotter for Equity Securities

Client Name/#	Trade Date	Settle Date	Buy/Sell	CUSIP	Security Symbol	Security Description	Quantity	Unit Price	Principal/Proceeds/Notional Value	Total Commission	Fees	Net Proceeds	Broker
155	1/1/00	1/3/00	B	1234567	MSFT	Microsoft Corp	100	\$100.00	\$10,000	\$10.00		\$9,990	BEST
123	1/2/00	1/5/00	S	89101112	IBM	IBM Corp.	500	\$100.00	\$50,000	\$50.00	\$1.67	\$49,948.33	HRZG

B. Sample Trading Blotter for Fixed-Income Securities

Client Name/#	Trade Date	Settle Date	Buy/Sell	CUSIP	Security Description 1 (Issuer)	Security Description 2 (Coupon Maturity, etc)	Quantity	Unit Price	Accrued Interest	Principal Value / Proceeds	Total Commission	Net Proceeds	Broker
155	4/2/98	4/6/98	B	802586AG2	SANTA ROSA CA PKG FACS DIST	4.60% 07-02-2004	50,000	100	\$95.83	\$50,000	\$0	\$50,095.83	Salomon
123	1/2/99	1/5/99	S	908640105	UNION TEXAS PETRO HOLDINGS INC	4.75% 9-15-2004	20	102	\$304.60	\$20,400	\$39.95	\$20,664.65	Schwab
6578	1/3/00	1/6/00	B	912795CJ8	UNITED STATES TREASURY BILLS	DUE 6/18/00	100,000	97.781	\$0	\$97,781	\$0	\$97,781	Auction

Exhibit 2

Client List

A. Client List for Separately Managed Accounts

Account Number	Client Name	Custodian	Account Type	Investment Strategy	Registrant has discretion? (Y/N)	Related Account? (Y/N)	Directed Brokerage Arrangement? (Y/N)	Name of Broker or Registered Rep (if directed)	Performance Fee? (Y/N)	Account Statements from Custodian? (Y/N)	Account Value as of Most Recent Billing

B. Wrap Fee Programs

Sponsor	Program Name	Total Fee	Registrant's Portion of Fee	Client Assets in Program





"Incentivizing Good Compliance"

by

Lori A. Richards

*Director, Office of Compliance Inspections and Examinations
Securities and Exchange Commission*

2008 Willamette Securities Regulation Conference
Willamette University College of Law
Portland, Oregon
October 30, 2008

Good Morning. I'm very pleased to be with you here today. I want to thank Willamette University College of Law, and particularly, Mike Eisenberg and Peter Letsou for inviting me to participate. I know Mike from his days before the SEC, and of course was honored to work with him while he was deputy general counsel and acting director of the Division of Investment Management at the SEC. Mike is keenly protective of investors' interests and was an able advocate for investors while at the SEC, on many issues and on many fronts. I consider Mike a friend and I also respect him for his constant advocacy for doing what's right by investors.

Before I begin, I am required to state that the views I express today are my own, and do not necessarily represent the views of the Commission or any other member of the staff.

This conference is intended to bring together current and former SEC and state securities regulators with leading securities attorneys across the country to discuss current developments in securities regulation, litigation and enforcement. As I speak to you today, our markets are undergoing unprecedented change. Once large firms no longer exist, and others have been acquired or merged. A money market fund has broken a dollar. The government has taken unprecedented steps to guarantee some money market funds, to buy troubled assets and to shore up credit markets.

During this time, the SEC has been aggressively working to police the markets, and to ensure that the "rules of the road" for public companies and market participants include full disclosure to investors and promote healthy capital markets. Addressing the extraordinary challenges facing our markets, the SEC has issued new regulations to strengthen capital markets and protections for investors, taken enforcement measures against market manipulation (including a landmark enforcement action against a trader who spread false rumors designed to drive down the price of stock), initiated examination sweeps, communicated with investors, and collaborated with domestic and foreign regulators around the world.

The SEC has an aggressive enforcement staff too — indeed in just this last year, we brought more than 650 enforcement actions (more than any year but one) involving all types of fraud that harm investors. And, in just the last year alone, we returned over one billion dollars to harmed investors — making the protections of the federal securities laws mean something to those investors who have been defrauded.

In the SEC's Office of Compliance Inspections and Examinations, we are responsible for examining securities firms — advisers, funds, broker-dealers, SROs, transfer agents — for compliance with the law. The examination program is comprised of over 800 examiners, accountants and lawyers across the country. Our job is to conduct examinations to identify compliance weaknesses, deficiencies and violations at SEC-registered firms. An important function of examinations is to identify weaknesses in compliance and other internal controls that could allow fraud and other types of violations to occur down the road — and to encourage and ensure that firms' beef up their internal controls to prevent this from happening. In this way, examiners play a proactive role in the securities markets in helping to prevent problems from occurring at all.

As you might expect, as an examiner my perspective on securities regulation is an acutely practical one. I see every day the way that securities firms go about implementing the securities laws. I see what works and what does not work in practice. So, it's this quite functional, non-theoretical perspective that forms my views.

I wanted to talk with you today about incentivizing compliance. This is an issue that I have been thinking about during the past year, as we've all witnessed compliance breakdowns and failures of various types. I'm referring to: January's revelations of *Jerome Kerviel's* alleged unauthorized trading at *Societe Generale*;ⁱ in February, the public learned of the fraud allegedly orchestrated by the former Chairman and CEO of *Refco*, in which he allegedly concealed trading losses and operating expenses during the company's IPO;ⁱⁱ in March, the SEC charged *Fidelity* with allegedly allowing its traders to accept lavish gifts from brokers courting its trading business and failing to seek best execution;ⁱⁱⁱ in April, the SEC charged stock trader *Paul Berliner* with allegedly spreading false rumors to intentionally drive down the price of a stock;^{iv} in May, the SEC charged *Banc of America Investment Services* with allegedly failing to disclose to clients that it favored two of its proprietary mutual funds when it made investments for its wrap fee clients;^v in June, the SEC accused *Bear Stearns'* hedge fund managers with allegedly fraudulently misleading investors about the funds' holdings;^{vi} in July, the SEC charged *E*Trade* with allegedly failing to have an adequate anti-money laundering compliance program to verify the identities of its customers;^{vii} in August, the SEC's Division of Enforcement reached agreements in principle with *UBS*, *Wachovia* and *Merrill Lynch* to buy back billions of dollars in auction rate securities from retail investors, many of whom believed that they were liquid investments;^{viii} and just last month, the SEC charged *AmSouth Bank* and *AmSouth Asset Management* with allegedly defrauding mutual funds by secretly using \$16 million of the fund's money to pay for the adviser's marketing and other expenses.^{ix}

As I look back on these and other alleged compliance failures, to me, they reinforce the necessity of organizations having front-end compliance

systems that would prevent similar problems from occurring. In any good organization, when things go wrong at the firm or at another firm in the industry — people dissect those incidents, asking "How was this possible?" "What could have prevented it?" "How might we have detected early signs of it sooner?" In this way, compliance failures often lead to stronger preventative controls at other firms in the industry.

The *Frank Gruttadauria* matter is a case in point. Remember him? He was the registered representative in Ohio who diverted his customers' account statements to his own P.O. box and sent his customers inflated account balances on fake account statements thereby perpetuating a massive fraud? ^x This incident led to an appreciation of the value of protections over customer changes of address, wire transfers and account statements, and improvements in controls across the industry. It's a perfect example of how compliance breakdowns can lead to strengthened compliance controls.

I don't underestimate the value of this kind of incident-driven learning. It is important and it leads to significant improvements in prevention and detection techniques. But, while we learn from failures, it seems to me that organizations should be focusing more attention on how to better *incentivize* strong compliance by employees in the first place.

Why Does Compliance Happen?

Stepping back a bit, before thinking about how to incentivize compliance, I think we first need to identify reasons why non-compliance occurs, and, on the flip side of that question, why compliance occurs. I posit that there are many different reasons why people don't comply with an obligation — for example, they may not be aware of an obligation, they may perceive that they will obtain a benefit by not complying, they may think that are unable to comply, and, they may simply disagree with the obligation.

If that's why non-compliance occurs, why does compliance occur? I think that compliance "happens" when three things occur: first, when a person understands what his obligations are; second, when he is able to comply with the obligation; and third, when he is willing to comply with the obligation (simply put, he knows what he has to do, he wants to do it, and he can do it). Let me describe each of these components briefly — and how we at the SEC have sought to address each of them in order to facilitate compliance with the securities laws.

The first requirement for compliance is that a person must *understand* their obligations. This is obvious to you, I'm sure, but I'm amazed at the number of times that SEC examiners find deficient practices and the person responsible claims they did not understand either that they had an obligation or its precise nature. For example, we often find that firms are not aware of compliance obligations with respect to new rules. It sometimes takes time for people to learn about and understand their obligation. This is why effective education and training are so important. For our part, we've included new rules in our *CCOutreach* programs, which are designed to help chief compliance officers learn techniques and strategies to strengthen their own firms' compliance programs. We also created a "plain English" summary of key provisions of the Investment Advisers Act and emailed it to some 10,000 advisory firms! In addition, we seek to provide clear explanations of the law and new rules whenever

possible.

The second requirement for compliance is that the person must be *able* to discharge their compliance obligations. Compliance obligations must not be unattainable. At the Commission, the SEC engages in a notice and comment process before implementing new rules, which provides us with input about (among other things) the feasibility of the proposed rule in practice.

It is the third requirement for compliance — a person's *willingness* to comply — that is perhaps the most complicated because it is inherently human and relies on an individual's own behavioral characteristics. For example, some people will be willing to comply because they place intrinsic value on doing what's right. As well, people's willingness to comply will be greater if they perceive that there is significant downside in not complying. This is why both regulators and compliance personnel spend so much time warning people about the harm that will befall them — for example, losing their job, their reputation, or their freedom — if they don't comply. This is deterrence — the "stick" — and it's a powerful motivator and indispensable in the toolkit of any compliance professional.

In addition to imposing deterrence for non-compliance, I think that people will also be more willing to comply when they perceive that there are positive benefits in doing so. Human beings are purposeful, and will behave in certain ways if they perceive they will be rewarded for doing so. This is where we get to incentives — the "carrot" — the positive reward for undertaking the behavior we seek. I think that there has been limited focus on incentives in securities compliance, and I wanted to discuss some of my thoughts on this topic with you today.

Incentives and Behavior

In the business world, firms provide incentives to their employees to draw performance, to achieve results or to meet other expectations of the organization. Most commonly, and perhaps most powerfully, incentives are financial, salary and bonuses. Incentives also take other forms, and include trips, titles, and other, softer, rewards. Incentives are provided to individual employees and also to groups of employees within divisions or units. Most commonly, incentives are provided to encourage production — production of sales, production of profit, and production of accounts.

Academic literature is filled with studies of how incentives work. There is ample evidence too that incentives can yield unintended results. In his recent book called *The Cheating Culture: Why More Americans Are Doing Wrong to Get Ahead*, the author David Callahan writes that rampant cheating in American society is due in part to incentive structures that unintentionally reward deception and cheating.^{xi} Callahan provides multiple recent examples of this phenomenon:

- In the 1990s, when a company instituted a production quota for its car repair staff, mechanics began performing unnecessary and costly maintenance.
- In the legal profession, pressed to bill as many hours as possible, ambitious young lawyers overcharge clients.

- In the medical profession, to ensure that insurers won't deny coverage to the patient, doctors exaggerate the symptoms of their patients.

In the corporate world, incentives can also yield unintended results. Incentive compensation plans were often cited as one cause of the financial frauds at *Enron* and *Worldcom*. Compensation incentives encouraged employees to achieve results at whatever cost.^{xii} And more recently, stock option compensation plans were gamed by some corporate executives.

In recent years, public policy has recognized the connection between incentives and behavior. Drawing the connection between compensation and compliance, one of the provisions of the Sarbanes Oxley Act, passed by Congress in response to corporate fraud, requires the CEO and CFO to reimburse the company for their bonus or incentive-based compensation if the company must restate its financial statements due to any material noncompliance, misconduct or with a financial reporting requirement (Section 304).

And, following the Sarbanes-Oxley Act, the Federal Sentencing Guidelines were amended to place a greater focus on prevention of violations and conformity with ethical standards, and they made high-level personnel more responsible for implementing and overseeing a compliance program. Added to the Guidelines for an effective compliance and ethics program was a requirement that "[t]he organization's compliance and ethics program shall be promoted and enforced consistently throughout the organization through ... appropriate incentives to perform in accordance with the compliance and ethics program ...".^{xiii}

More recently, the new Emergency Economic Stabilization Act of 2008 established the Troubled Asset Relief Program (TARP) at the Department of the Treasury.^{xiv} That law contains various standards for executive compensation and corporate governance and draws a linkage between compensation and risk-taking. It requires that any firm that sells troubled assets to the Treasury or participates in the capital purchase program under the TARP have limits on executive compensation that exclude incentives for senior executive officers to take unnecessary and excessive risks that threaten the value of the financial institution.^{xv} John White, the Director of the SEC's Division of Corporation Finance spoke about these new provisions last week, and also announced that the SEC's Division of Corporation Finance will review the annual reports of the largest U.S. financial institutions that are public companies, with particular focus on these firms' disclosures concerning their executive compensation.^{xvi}

Incentives in the Securities Industry

With respect to securities firms and investment advisers that are registered with the SEC (and examined by SEC examiners), there are many examples of incentive-based compensation systems. The most common compensation system historically has been the commission-based sales compensation paid to registered representatives for selling a security. This compensation structure incentivizes sales, but its exclusive focus on sales may encourage sales that are inappropriate for the customer. For example, in order to generate a commission, a registered representative may sell securities that

are unsuitable for the customer, or buy and sell securities excessively ("churning"). And, when sales commissions are higher for the sales of certain products, such as variable annuities, a registered representative can be tempted to recommend them over other products that may be more suitable for the customer.^{xvii} The movement to asset-based compensation removed this incentive and hopefully, will reduce some of the sales practice problems that we've seen. Ironically, however, there are also examples of "stale" or inappropriately unmanaged accounts, which may have been incentivized by asset-based fees.

Some investment advisers are compensated based on the performance of their accounts. This structure aligns the performance-interests of the client and the adviser. It can, however, incentivize risk-taking beyond that which is appropriate for the customer or investor and beyond disclosures in order to pull in higher returns. Performance-based compensation could also incentivize the overvaluation of client portfolios in order to generate a higher performance-based fee.

It seems to me that one way to reduce the unintended incentives that can arise in an incentive compensation system is to ensure that the compensation system incentivizes production but in a manner that is consistent with the law, the firm's code of ethics and the internal compliance and risk culture of the firm. If the firm's compensation incentives include only hard production numbers — how many accounts did you open, how much profit did you generate, how many deals did you ink — the firm may encourage employees do so at any cost, and at cost to the firm, to its reputation, and to its customers and clients. We all know the adage "*you get what you pay for*," but it is perhaps more true that "*you don't get what you don't pay for*."

The performance that most firms want includes adherence to the firm's own policies and procedures with respect to internal controls and compliance, and it includes adherence to high ethical standards. As a starting point, the firm's compliance and internal controls infrastructure must be strong enough to underpin these incentives — this means that the firm must compensate its compliance staff adequately and ensure that they have sufficient resources to do the job. The responsibility to ensure a strong culture of compliance and a compliant organization, however, rests with managers and leaders of the firm.

Given that firm leaders and managers have this responsibility, why not incentivize it to happen, right along with incentivizing production? Here are some ways that I think securities firms might better incentivize compliance by their employees with the firm's risk and compliance controls:

- *Be clear about expectations.* Managers and employees should be aware that compliance with the firm's internal risk management and compliance policies is expected, and performance expectations should be explicit on this point.
- *Reward managers who achieve compliance.* Managers could be compensated in part based on their branch's or unit's compliance activities (results of surveillance reviews, internal reviews, customer satisfaction levels). Positive results get higher compensation.

- *Reward managers who cultivate a culture of compliance.* Many organizations are measuring their employees' attitudes towards ethics and compliance by the use of surveys. Some firms then tie a component of their senior managers' compensation to the attitudes expressed by their unit's employees. Positive results get higher compensation.
- *Make strong compliance an advertised goal.* In industrial plants, firms advertise the number of days with a "clean" safety record — to remind employees about the importance of safety on the job. Other organizations could take a lesson and publicize the number of days without a customer complaint, arbitration, or aggrieved customer.
- *Reward employees for considering compliance issues.* Employees could be incentivized to approach compliance staff early on with questions about compliance — well before the deal, or the product or the transaction is launched.
- *Consider new incentives.* While sales incentives may be a part of the fabric of the securities business, wouldn't a reward based on the satisfaction levels of the clients of the registered representative or advisory representative be more meaningful? (satisfaction could be measured by, for example, whether the investor believes that the financial adviser understands the investor's needs, objectives, and risk tolerance; is responsive; effectively invests their funds; adequately discloses risks and costs; and provides understandable explanations about investment options). Wouldn't that type of reward incentivize the kind of long-term relationships that firms so want to develop?
- *Incentives impact risk.* Because incentives drive behavior, an organization's risk-assessment process could take into account the incentives that exist that encourage and reward compliance, and could identify areas and employees who do not operate with these incentives. Firms could include the latter as areas that may present higher risk and may warrant closer review. In addition, when organizations conduct special reviews or inquiries of compliance breakdowns, they could include an evaluation of the role that incentives played.

I'm certain that there are other ways too that organizations could better incentivize strong compliance — I hope that organizations will take time to consider how they might better incentivize strong compliance, to help encourage firm employees operate in accordance with the law, the firm's code of ethics and its internal compliance and risk controls.

Thank you for your attention. I have enjoyed speaking with you today about how organizations might better incentivize good compliance. I look forward to hearing from you on this issue — what incentives to foster strong compliance have you observed? What has worked? What does not work? Most importantly, I hope that there will be constructive thinking within securities firms about how they might better incentivize strong compliance practices right from the start.

Endnotes

ⁱ "French Bank Says Rogue Trader Lost \$7 Billion," Nicola Clark and David Jolly, *New York Times*, January 25, 2008.

ⁱⁱ *SEC v. Phillip R. Bennett*, 08 CV 1631 (GEL) (S.D.N.Y. filed February 19, 2008) <http://www.sec.gov/litigation/litreleases/2008/lr20460.htm>

ⁱⁱⁱ <http://www.sec.gov/news/press/2008/2008-32.htm>

^{iv} *SEC v. Paul S. Berliner*, Civil Action No. 08-CV-3859 (JES) (S.D.N.Y.) April 24, 2008 <http://www.sec.gov/news/press/2008/2008-64.htm>

^v <http://www.sec.gov/news/press/2008/2008-72.htm>

^{vi} *SEC v. Ralph R. Cioffi and Matthew M. Tannin*, Civil Action No. 08 2457 (FB) (E.D.N.Y. June 19, 2008) <http://www.sec.gov/litigation/litreleases/2008/lr20625.htm>

^{vii} <http://www.sec.gov/news/press/2008/2008-156.htm>

^{viii} <http://www.sec.gov/news/press/2008/2008-171.htm>,
<http://www.sec.gov/news/press/2008/2008-176.htm>
<http://www.sec.gov/news/press/2008/2008-181.htm>

^{ix} <http://www.sec.gov/news/press/2008/2008-222.htm>

^x *SEC v. Frank D. Gruttadauria, et. al*, Civil Action No. 1:02CV324 (filed February 21, 2002) <http://www.sec.gov/litigation/litreleases/lr17369.htm>;
<http://www.sec.gov/litigation/litreleases/lr18678.htm>;
<http://www.sec.gov/litigation/admin/34-49760.htm>.

^{xi} David Callahan (Harcourt, 2004).

^{xii} Malcolm S. Salter "Skilling's Appeal and Enron's Legacy," *BusinessWeek*, August 21, 2008.

^{xiii} Federal Sentencing Guidelines, Chapter 8, §8B2.1 "Effective Compliance and Ethics Program," available at <http://www.ussc.gov/guidelin.htm>. Also added was a requirement that organizations take appropriate disciplinary measures for engaging in criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct.

^{xiv} Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

^{xv} See TARP Capital Purchase Program, Interim Final Rule, 73 FR 62205, October 20, 2008. See also, TARP Capital Purchase Program Summary Term Sheet, available at <http://www.ustreas.gov/press/releases/reports/document5hp1207.pdf>.

^{xvi} See *"Executive Compensation Disclosure: Observations on Year Two and a Look Forward to the Changing Landscape for 2009"* John W. White, Director, Division of Corporation Finance, SEC (October 21, 2008) <http://www.sec.gov/news/speech/2008/spch102108jww.htm>.

^{xvii} NASD (now FINRA) rules restrict the payment and acceptance of non-cash compensation in connection with the sale of direct participation programs, variable insurance contracts, investment company securities, and public offerings of real estate investment trusts and other securities. NASD also prohibits internal non-cash sales contests in connection with the sale of variable insurance contracts or investment company securities unless they meet certain criteria, including that such contests be based on principles of total production and equal weighting.

<http://www.sec.gov/news/speech/2008/spch103008lar.htm>

[Home](#) | [Previous Page](#)

Modified: 11/04/2008





**Speech by SEC Staff:
Compliance Through Crisis: Focus Areas for SEC
Examiners and Compliance Professionals**

by

Lori A. Richards

*Director, Office of Compliance Inspections and Examinations
U.S. Securities and Exchange Commission*

National Society of Compliance Professionals
National Meeting
Philadelphia, Pennsylvania
October 21, 2008

Good Morning. I'm very pleased to be with you here today at the National Meeting of the National Society of Compliance Professionals. I believe that this is the largest professional organization of compliance professionals in the securities industry, so you carry a lot of clout!

Before I begin, I am required to state that the views I express today are my own, and do not necessarily represent the views of the Commission or any other member of the staff.

This event and others like it are so important — they provide an opportunity to share information about cutting edge compliance practices, about emerging compliance risks, and about strategies to help establish strong compliance programs and instill a healthy culture of compliance. Your role as compliance professionals is critical in any market environment, but in today's turbulent times, it is essential. Your job each day is to educate, to guide, to investigate, to test and sometimes to insist on adherence to the law and to the firm's policies, and sometimes, to just say no! Your job is important in any environment, and it is just as or more important now.

The compliance function within firms is critical in helping to assure operations in compliance with the law, and it must continue to be fully and adequately resourced. While not profit centers, firms must remember that their compliance programs (and related legal functions, as well as the information technology programs that support a well-run compliance program) are essential to their operations — reductions in resources to these programs would be ill-advised. Securities firms cannot now afford to reduce vigilance in compliance.

In today's environment, perhaps the most important thing you can do as a compliance professional is to remind firm employees of their obligations to

investors — for an adviser, the fiduciary obligation to clients, and for a broker, the obligation to follow just and equitable principles of trade. These obligations must continue to motivate and inform the way that the firm interacts with clients, customers, and investors. In addition to this reminder, however, there are areas where you will want to pay particular attention to compliance obligations. I will describe some of those this morning. Finally, you cannot let slip the other ongoing compliance responsibilities that the firm has, I will describe some of these priority areas as well.

As I speak to you today, our markets are undergoing unprecedented change. Once large firms no longer exist, and others have been acquired or merged. Securities firms that once stood alone are now parts of large banks. A money market fund has broken a dollar, and the Treasury has implemented a new program to guarantee certain money market funds from loss and the government has taken unprecedented steps to buy troubled assets and shore up credit markets. These are sudden and significant changes, and while we won't see their full impact for some time, today, in the securities compliance world, our work could not be more important.

It's worth remembering, for all of us who work administering compliance programs under the securities laws, that the underlying tenets of the securities laws are quite simple and provide meaningful protections to every investor every day:

- Companies publicly offering securities to investors must tell the public the truth about their businesses, the securities they are selling, and the risks involved in investing — enabling investors to make informed investment decisions.
- People who sell and trade securities and provide investment advice — brokers, dealers, advisers and exchanges — must treat investors fairly and honestly, putting investors' interests first.

In the current credit crisis, the SEC has been aggressively working to police the markets, and to ensure that the "rules of the road" for public companies and market participants include full disclosure to investors and promote healthy capital markets. While a small agency (only 3,800 staff), the SEC packs clout through its experienced and dedicated staff. Addressing the extraordinary challenges facing our markets, the SEC has issued new regulations to strengthen capital markets and protections for investors, taken enforcement measures against market manipulation (including a landmark enforcement action against a trader who spread false rumors designed to drive down the price of stock), initiated examination sweeps, communicated with investors, and collaborated with domestic and foreign regulators around the world.

The SEC is an aggressive police force too — we bring hundreds of enforcement actions each year to protect public investors from fraud. Indeed in just this last year, we brought more than 650 enforcement actions, more than the year before, involving all types of fraud that harm investors — corporate non-disclosure, ponzi schemes, insider trading, failures to value assets correctly, and other types of frauds. The protections of the securities laws are meaningful and have real consequences for

investors. In just the last year alone, we returned over one billion dollars to harmed investors — making the protections of the federal securities laws mean something to those investors who have been defrauded.

And, in the Office of Compliance Inspections and Examinations, we are keenly focused on issues that present risk to investors. I wanted to highlight some of the areas that SEC examiners will be focusing on in the months ahead in our examinations of registered investment advisers, investment companies, and broker-dealers — and suggest that these are areas that you might focus attention on as well.

Let me start with the “landscape” because the sheer number of registered firms subject to our examinations impacts our actions quite directly. At the start of FY 2009:

- There are approximately 11,300 registered investment advisers and 950 fund complexes with over 8,000 mutual fund portfolios (this is a highly transient population: approximately 1,200 advisers became registered and 750 de-registered in FY 2008).
- There are approximately 5,600 broker-dealers, 174,000 branch offices, and 676,000 registered representatives (as more firms have consolidated, the broker-dealer registrant pool has declined slightly in recent years, while the number of branch offices has increased dramatically). And, there are approximately 410 SEC-registered transfer agents.

Our program is risk-based, which means that we seek to accord resources to those firms and issues that present the greatest risk to investors. Our overall examination plan consists of numerous complementary components: routine and periodic examinations of those advisers (about 1,000) that are considered “higher risk;” routine examinations of large broker-dealer firms to evaluate their internal controls; “oversight” examinations of broker-dealers to evaluate the SROs’ regulatory programs; cause exams based on indications of violations; “sweep” exams focused on particular risk areas; random examinations of lower risk advisers; and visits to newly-registered advisers. In addition to these types of examinations, we will also closely monitor the compliance activities and controls of certain large advisers and broker-dealers.

We’ve also sought to leverage compliance results from firms’ own compliance programs by encouraging firms’ own compliance professionals to be aggressive in assuring compliance with the securities laws. In the coming year, we will continue this work as well — we will continue our *CCOutreach* programs for chief compliance officers. Our National Seminar for adviser and fund CCOs is November 13, and we just announced that our National Seminar for broker-dealer CCOs, in coordination with FINRA, will be held on March 10, 2009. We will also continue to issue *ComplianceAlerts* that summarize results of recent examinations so that all firms can benefit from our insights into both what can go wrong, and also, what particular practices seem to help make things go right.

Our examination program includes focus areas and exam initiatives that are particularly critical in today’s market environment. While these are not new areas, they are timely now and examiners will be paying special attention

to compliance in these areas. These areas include:

- **Portfolio management:** recent losses may provide an impetus for portfolio managers to trade more aggressively than they should or to deviate from investment objectives in order to make up losses, and perhaps also to catch-up on performance-based fees. This is an area where compliance personnel should be active.
- **Financial controls,** including compliance with net capital and customer control requirements by broker-dealers, as well as these firms' risk management and internal control procedures. While the Division of Trading and Markets will no longer be supervising the holding companies of large broker-dealer firms — OCIE examiners will continue to focus attention on controls within the registered broker-dealer, which are intended to protect investors' accounts with a broker-dealer. And, if you're an adviser in precarious financial condition — you must disclose this fact to clients. This is an area where your focus is warranted.
- **Valuation,** at all types of registrants, including controls and procedures for valuation of illiquid and difficult-to-price securities at all registrants. Reluctance to fair value or mark down prices cannot take precedence over the firm's pricing procedures — investors and fund shareholders have a right to know the current value of their holdings. If you work for a broker-dealer that provides quotes or for an investment adviser or other user of broker quotes — be particularly alert to and look for the possibility of "accommodation quotes" — which don't reflect prices at which the security could actually be sold. At its worst, this could be fraudulent conduct. A reminder too — under accounting rules (FAS 157), issuers must classify their assets within a hierarchy. For those assets valued by using a broker's quote or a price from a pricing service — you should be sure that you understand whether the quote or price is based on actual transactions, reflects the willingness of the broker to trade at that price, or is based on a model or another methodology. Among strong practices in this area are to require multiple sources of pricing information, and also to regularly go back and compare the actual prices realized on any sale to the fair values used: then, determine the reasons for any wide gaps and implement improvements in pricing processes. This is an area where your focus is needed now — be sure that your firm is implementing its controls and its oversight over pricing.
- **Sales of structured products** by broker-dealers and advisers. Of special note — given that investors may be particularly looking for lower-risk investment products, examiners will focus on products marketed as being relatively "safe," such as principal protected notes and other products, and will review the adequacy of disclosures concerning credit risk, liquidity, and investment risk. Conversely, investors may be looking to recoup losses, and may be more vulnerable to sales of high-risk, high-return products. You will want to focus on both types of products and make sure that representations are accurate and that your firm is treating investors fairly.
- **Controls and processes at recently merged or acquired firms,** both advisers and broker-dealers. This is an area where compliance

staff must be active — to help make sure that controls and processes do not fall through the cracks in a merged organization.

- **Money market funds**, including, at a minimum, compliance with Rule 2a-7 regarding the creditworthiness of portfolio securities, shadow pricing, and compliance oversight — and more broadly, whether funds' are stretching for yield and subjecting the fund to excessive undisclosed risk. We have examinations underway. The problems experienced by money market funds should be seen as cautionary for all managers and CCOs of money market funds.
- **Short selling** and compliance with Regulation SHO and filings of Form SH. Examiners are also focusing on firms' policies and procedures to prevent employees from knowingly creating, spreading, or using of false or misleading information with the intent to manipulate securities prices, and will be concluding a sweep of broker-dealers and hedge fund advisers in this area.

Beyond these specific compliance risk issues, in times of financial strain, people may act in uncharacteristic ways — in order to conceal losses, inflate revenues or profits, to stay in business or just to avoid delivering bad news. Examiners will be alert for indications of fraud and "acts of desperation" by individuals and firms that are under financial duress. As compliance personnel, however, you are much closer to the scene than we are — and you should be aware of and alert to the increased possibility that individuals under stress may take fraudulent or deceptive actions. Checks and balances are critical in this environment. You should insist on absolute compliance with policies and procedures, there should be no possibility of "suspending" compliance. And it would be timely for you to remind firm employees of your presence and make clear to every employee in the firm that no shortcuts will be allowed.

In addition to these focus areas, OCIE examiners will also be focusing on other compliance risks, and so too must you. We cannot afford to pay *less* attention to any of these issues. Let me describe several of these areas:

- **Suitability and appropriateness of investments for clients:** Examiners will focus on whether securities recommended and investments made for clients and funds are consistent with disclosures, the client's investment objectives and any investment restrictions, and with the broker or adviser's obligations to clients to only recommend securities that are suitable or appropriate. We'll focus in particular, on how firms are interacting with their senior customers and clients. We'll also focus on structured products and other complex derivative instruments, variable annuities, niche ETFs, managed pay-out funds, and 130/30 funds.
- **Disclosure:** Examiners will focus on ADVs, performance advertising, marketing, fund prospectuses and any other information provided to clients. This is a good time for you to review your firm's disclosures to investors and shareholders. Make sure that any steps the firm has taken in recent days or weeks to deal with the credit crisis are consistent with the firm's disclosures. Examiners will be specifically looking at how the firm represents its participation in Treasury's money market guarantee program, the existence of SIPC coverage,

and at advertised performance figures. Consider your disclosures as your "Constitution" — even in a crisis, it's your governing document, and it must match your practices.

- **Controls to prevent insider trading:** We're focusing on the adequacy of policies and procedures, information barriers, and controls to prevent insider trading and leakage of information including the identification of sources of material non-public information, surveillance, physical separation, and written procedures. Controls to prevent insider trading should be strong in any environment.
- **Trading, brokerage arrangements and best execution:** We'll be looking at whether brokerage arrangements are consistent with disclosures, whether the firm seeks best execution, and whether soft dollars are used appropriately (consistent with disclosures), Reg NMS and direct market access arrangements. We will particularly scrutinize the use of an affiliated broker-dealer or any undisclosed relationships with a broker-dealer for excessive commissions, kick-backs and other conflicted relationships. Your best execution committees will want to particularly review execution quality in current markets.
- **Proprietary and employees' personal trading:** This is a basic part of any compliance program — when we find weaknesses in this area, it makes us wonder about the firm's commitment to addressing other conflicts of interest. This is not an area to be overlooked.
- **Undisclosed payments:** Examiners are looking for compensation or payment arrangements that may be part of revenue-sharing, or other undisclosed arrangements with third parties. These payments may be made to increase fund sales or assets under management (such as fund networking fees and payments by advisers to broker-dealers for obtaining space on the firms' recommended adviser list). Undisclosed payments may also involve misappropriation of adviser/fund/broker-dealer assets by, for example, creating fictitious bills and expense items, or receiving kick-backs from a service provider.
- **Safety of customer assets:** Examiners will look at whether brokers, funds and advisers have effective policies and procedures for safeguarding their clients' assets from theft, loss, and misuse. This is a good time for you too to assess controls in this area. Make sure that advisory clients' money is with a qualified custodian and review prime brokerage relationships. You may want to ensure that the process for sending account statements to clients has controls to ensure that the account statements cannot be intercepted or falsified. Examiners will also continue to focus on controls for compliance with Regulation S-P with respect to customer information.
- **Anti-money laundering:** Examiners will look at whether funds and broker-dealers are complying with obligations under the securities laws, the Patriot Act and Bank Secrecy Act to have effective policies and procedures to detect and deter money-laundering activities, whether these policies and procedures are regularly tested for continued effectiveness, and whether actual practices are consistent with the policies and procedures.

- **Compliance, supervision, and corporate governance:** While this is the last item I'll list, it's the most important — because it underpins all the other compliance responsibilities that firms have. In the coming year, examiners will focus in particular on supervisory procedures and practices at large branch offices of broker-dealers and at advisory branch offices, on supervision and controls over traders, whether funds have appropriately-constituted boards and have considered required matters (e.g., fair value procedures), and whether firms have implemented effective internal disciplinary processes. Also, we'll examine: firms that advertise themselves as allowing maximum independence to registered representatives; for abuses in transferring customer accounts as registered representatives move to new firms; supervision of producing branch managers; bank broker-dealer branches; and the adequacy of firms' testing to detect unsuitable or aberrant trades.

For advisers and mutual funds, in that this is the fifth year of both the Compliance Rule and our *CCOutreach* efforts for adviser and fund CCOs, we hope to see improvements in firms' compliance programs, and in particular, that significant deficiencies were identified promptly and corrected appropriately by firms.

* * *

These are challenging times, no doubt. The SEC has been and will continue to guard the interests of investors. Industry compliance professionals too play an indispensable role in fostering and assuring investor protection and the integrity of our markets. As I said at the outset, I think that the first thing that you might do in the current environment is to remind firm employees of their obligations to investors — for an adviser, the fiduciary obligation to clients, and for a broker, the obligation to follow just and equitable principles of trade. These obligations must continue to motivate and inform the way that the firm interacts with investors.

I have shared with you today some of the issues that SEC examiners will be focusing on in the coming months — and these are areas where I hope you too will focus your attention. Finally, you cannot let slip the other ongoing compliance responsibilities that the firm has, and I have described some of these priority areas as well.

I hope this information will be helpful to you in your work, and I look forward to continuing to work with you to help improve and assure strong compliance practices in the securities industry.

Thank you.

<http://www.sec.gov/news/speech/2008/spch102108lar.htm>





CCOutreach 2007 Regional Seminars

This document is intended to provide investment company and investment adviser Chief Compliance Officers with factors or controls to consider when evaluating the effectiveness of their firms' compliance programs. It provides information regarding documents and information examiners request, analyses examiners perform, and common deficiencies found on examinations for the following areas:

- *Disclosures and Filings and Books and Records*
- *Portfolio Management*
- *Performance Advertising and Marketing*
- *Brokerage Arrangements and Execution, Trade Allocation, and Soft Dollars*

The forensic measures discussed in this document are not an exhaustive list. Rather, such measures are examples of tests, some of which are already widely used by both registrants and examiners.

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its staff. The views expressed by the staff in these written materials are those of the staff and do not necessarily reflect the views of the Commission or of other Commission staff.

Disclosures and Filings and Books and Records

A. Documents and Information Examiners Frequently Request and Analyses Frequently Performed

1. *Information Disclosures, Reporting, and Filings*

- **Form ADV Parts IA and II and any alternative written disclosure statement used in lieu of Part II.**
 - ✓ Determine whether annual and/or updating amendments were filed in a timely manner.
 - ✓ Review Form ADV for omissions and/or misleading information.
 - ✓ Determine whether any alternative brochure used contains at least the same information required by Form ADV Part II.
- **Wrap fee brochure prepared in response to Schedule H of Form ADV.**
 - ✓ Review for material omissions and/or misleading information.
- **Copies of any internally generated position or performance statements provided to clients.**
 - ✓ Compare internally generated statements to records from third-parties (e.g., custodian or broker) to ensure accuracy of reported information.
 - ✓ Review performance statements for omissions and/or misleading information.
- **Fund prospectuses, statements of additional information, and annual and semi-annual reports, and pooled investment vehicle offering documents.**
 - ✓ Review offering documents, prospectuses, and statements of additional information for completeness and to identify any omissions and/or misleading information.
 - ✓ Determine whether annual and semi-annual reports were filed in a timely manner.

- **Disclosure controls and procedures required by Rule 30a-3 of the Company Act and concerning the certification and filing of Forms N-CSR.**

- ✓ Review controls and procedures to determine effectiveness.

2. *Books and Records*

- **Advisory, sub-advisory, administration, distribution, and custodial agreements entered into by the firm.**

- ✓ Determine whether payments are made in accordance with the terms of all agreements.

- ✓ Review contracts for both required and prohibited provisions.

- **Documentation of annual offer of Form ADV Part II.**

- ✓ Determine whether Form ADV is offered or delivered annually.

- ✓ Ensure that the firm maintains a copy of each statement given or sent to any client and a record of each offering.

- **Memorandum of each order given by the firm for the purchase or sale of any security.**

- ✓ Ensure that the firm maintains order memoranda and determine whether the order memoranda contain all required information.

- **Access persons' initial and current annual holdings reports and quarterly transaction reports.**

- ✓ Review reports to determine whether they contain all required information.

- ✓ Determine what reviews, if any, the firm conducts based on the information contained in the reports.

B. Common Deficiencies

1. *Information Disclosures, Reporting, and Filings*

- **Inaccurate or incomplete disclosures**

Examples:

- Firms did not disclose all material conflicts of interest that surround and influence their businesses.

- Firms did not adequately disclose all industry activities and affiliations.
- Firms did not adequately describe their codes of ethics.
- Wrap fee brochures did not include all material facts about the wrap fee program.
- Fund prospectuses and statements of additional information contained inaccurate or misleading information.
- **Delivery of disclosures to clients**

Examples:

- Firms did not provide written disclosure statements to new and prospective advisory clients within the required time frame.
- Firms did not provide or offer written disclosure statements to existing clients at least annually.

- **Timeliness of filings**

Example:

- Firms did not file annual amendments to Form ADV within 90 days of their fiscal year end.

2. *Books and Records*

- **Completeness**

Example:

- Firms did not record all financial transactions, indicating that they may not have adequate accounting controls in place.
- Firms did not maintain all supporting records for performance from previous employment.

- **Accuracy**

Examples:

- Firms' books and records were not true and accurate.

- Firms' financial statements did not reconcile to source documents and bank statements.
- Internally-generated client statements did not reconcile to third-party statements.

- **Accessibility**

Examples:

- Firms' books and records were not organized or were not easily accessible.
- Firms maintained records on an informal basis, indicating that they may not have adequate controls in place.
- Firms stored records electronically, but did not arrange or index the records to permit easy location, access, and retrieval.

- **Maintenance**

Examples:

- Firms' books and records were not preserved for the correct length of time or were not stored in an appropriate location.
- Firms' records supporting performance advertising calculations were not kept for five years from the end of the fiscal year in which they were last published or disseminated.
- Firms' codes of ethics and compliance procedure records did not include all policies that had been in effect within the past five years.

- **Safety**

Examples:

- Firms stored records electronically, but did not have procedures to reasonably safeguard the records from loss, alteration, or destruction.
- Firms did not limit access to records to properly authorized personnel.

C. Controls to Consider

1. *Information Disclosures, Reporting, and Filings*

- Create a compliance calendar to ensure that all filings and updates are made or provided to clients in a timely manner.

2. *Books and Records*

- Periodically sample performance records and order memoranda to ensure that they are maintained properly.
- Periodically review all contracts to ensure that the terms are current and that fee schedules are accurate.
- Periodically test the disaster recovery plan.

Portfolio Management

A. Documents and Information Examiners Frequently Request and Analyses Frequently Performed

- **Firm's trading blotter or purchase and sales journal, including the transactions of the firm's access persons and proprietary accounts.**
 - ✓ Review trading activity to determine whether investments are in line with client objectives.
 - ✓ Determine if block trades were allocated using average price and consistent commission rates within the block.
 - ✓ Determine whether any principal and/or cross trades have been conducted. Verify that appropriate disclosures have been given and client consent obtained. Verify prices at which such trades were conducted and commissions charged. Cross trades could also be conducted in an effort to "dump" securities on certain clients to benefit other clients.
 - ✓ Review end of quarter/end of year trading for any evidence of "window dressing."
 - ✓ Calculate portfolio turnover for a sample of client accounts. Compare the turnover to the stated investment objective to look for disparities.
 - ✓ Review proprietary and access person accounts for possible frontrunning and/or personal securities policies and procedures violations as well as execution prices and commission rates that are more favorable than those for client accounts.
- **Performance returns for each client account for a specified period.**
 - ✓ Compare performance among accounts and composites to look for performance disparities for indications of favoritism or inequitable allocations.
 - ✓ Compare performance of personal, related, or proprietary accounts versus the performance achieved by clients for indications of favoritism toward insiders.
 - ✓ Calculate and compare the percentage of profitable trades in client accounts and personal, related, or proprietary accounts.

- **Firm's records pertaining to each client account, including advisory agreement, correspondence, fee invoices, custodial statements, internally generated statements, etc.**
 - ✓ Review documentation of client objectives and restrictions. Compare these with portfolio holdings and transactions.
 - ✓ Review fees for accuracy and consistency with advisory agreement and disclosures.
 - ✓ Compare third-party custodial statements to firm's internally generated statements and review trade and billing errors.
 - ✓ Evaluate controls used to ensure compliance with disclosures made to clients regarding portfolio management activities.
- **A list of publicly traded companies of which any officers, directors or affiliates of the firm serve as officers or directors.**
 - ✓ Determine whether the firm places its own interests above those of clients in making investment decisions.
 - ✓ Determine whether conflicts of interest are properly disclosed to clients.
- **A list of any sub-advisory arrangements the firm has with other investment advisers or money managers.**
 - ✓ Review due diligence the firm conducts on sub-advisers to ensure that client accounts are managed in accordance with their objectives.

B. Common Deficiencies

- **Misleading or incomplete disclosures**

Examples:

- Firms did not disclose all conflicts of interest which impact their investment decision making abilities.
- Firms did not make required disclosures regarding voting of client proxies.
- Firms did not disclose to clients invested in securities such as variable insurance products and mutual funds that they are paying several layers of investment advisory fees.

- **Inadequate policies and procedures**

Examples:

- Firms did not have effective policies and procedures in place to ensure that portfolios are managed according to client objectives and restrictions.
- Firms did not establish effective policies and procedures to control and monitor conflicts of interest which impact investment decision making abilities.
- Firms did not effectively review portfolio management by sub-advisers to ensure that client assets are managed in accordance with their objectives.
- Firms did not have sufficient controls in place to ensure the accurate deduction of advisory fees from client accounts.
- Firms did not review the suitability of wrap fee programs for clients.

C. Controls to Consider

- Regularly communicate with clients regarding their objectives, document communications and resulting changes, and compare objectives to trading activity.
- Systematically review client accounts to ensure that all investments and associated risks are suitable for the client.
- Periodically conduct performance comparisons of accounts with like objectives to determine consistency of portfolio management.
- Regularly generate cash holdings reports to identify any large or unnecessary cash balances.
- Engage multiple independent pricing services to value the same portfolio on a systematic basis.

Performance Advertising and Marketing

A. Documents and Information Examiners Frequently Request and Analyses Frequently Performed

- **The specific compliance policies and procedures that govern marketing and performance advertising.**
 - ✓ Determine whether the firm has established internal controls to ensure the accurate calculation of performance and the use of such information in ways that are not misleading.
 - ✓ Determine whether the firm has established internal controls to ensure that marketing and distribution activities are consistent with regulatory requirements and disclosures.
- **Copies of advertisements, promotional brochures, pamphlets and other materials, including composite or representative reports and data, used to inform or solicit clients or shareholders.**
 - ✓ Review materials for specific prohibitions outlined in Rule 206(4)-1 including: testimonials, past specific recommendations, and false or misleading statements.
 - ✓ Determine whether fund sales literature includes all information required by Rule 34b-1.
 - ✓ Determine the accuracy and adequacy of disclosures made in such materials.
 - ✓ Review claims of compliance with Global Investment Performance Standards for accuracy.
- **Copies of recently completed RFPs (Requests-for-Proposals) and third-party consultant questionnaires.**
 - ✓ Review responses for accuracy and ensure disclosures are adequate and consistent with the firm's other performance and advertising materials.

- **Account inclusion criteria the firm employs in the construction of any composite performance results.**
 - ✓ Determine whether the firm has developed written criteria that fully describe how composites are created and maintained and the methods and authorizations necessary to make changes.
 - ✓ Review all accounts to determine whether the firm's inclusion criteria are consistently and reasonably applied.
- **Records substantiating advertised performance.**
 - ✓ Compare internal calculations indicating asset values, capital additions and withdrawals, and periodic performance returns with corresponding custodial statements.

B. Common Deficiencies

- **Omitted or misleading disclosures**

Examples:

- Firms did not include the disclosures necessary to prevent their advertising from being misleading.
- Firms did not reflect the deduction of advisory fees in performance numbers.
- Firms did not disclose whether and to what extent the results portrayed the reinvestment of dividends and other earnings.
- Firms did not disclose all material facts relevant to a comparison of performance results to an index.

- **Inaccurate returns**

Examples:

- Advertised returns differed from actual returns calculated by the firm.
- The review and approval process for marketing materials is flawed and inaccuracies are not noted.
- Potential clients or shareholders were materially misled by inflated performance materials.

- **Inappropriate advertising of past specific recommendations**

Examples:

- Firms inappropriately provided examples of investment recommendations made during prior periods, and the performance generated from these investments, in presentations to clients.
- Firms inappropriately included examples of past recommendations and their profitability in their marketing materials.

- **Inaccurate claims of performance calculations in compliance with GIPS**

Examples:

- Firms claimed that they calculated performance in a manner that was consistent with GIPS, but were not in compliance with all of the GIPS requirements.
- Firms did not document their policies and procedures used in establishing and maintaining compliance with all the applicable requirements of GIPS.

- **Inadequate policies and procedures**

Examples:

- Firms lacked sufficient policies and procedures addressing marketing and performance advertising.
- Policies and procedures did not ensure that third-party consultants received accurate presentations.
- Policies and procedures were not adequate to ensure that the firms were in compliance with all applicable requirements of GIPS prior to making a claim of such compliance.
- Policies and procedures did not require a consistent comparison of composites to appropriate benchmarks.
- Policies and procedures did not ensure accurate composite descriptions.

C. Controls to Consider

- Ensure that a compliance person reviews marketing materials and that only those materials reviewed and approved by compliance are used.
- Regularly compare all composite accounts to their respective benchmarks to ensure proper composite construction and maintenance.
- Limit employee access to performance data.
- Perform periodic sampling and random sampling of the performance information to ensure the integrity of the data.
- Review and update performance policies and procedures to accurately reflect firm practices.

Brokerage Arrangements and Execution, Trade Allocation, and Soft Dollars

A. Documents and Information Examiners Frequently Request and Analyses Frequently Performed

1. Brokerage Arrangements and Execution

- **A list of affiliated broker-dealers featuring their affiliation and a description of their clearing arrangements.**
 - ✓ Review the total brokerage allocated to the affiliated broker. Determine whether the use of the affiliated broker is adequately disclosed.
 - ✓ Determine whether the brokerage and execution quality received by the affiliated broker is periodically and systematically reviewed; compare to other brokers to determine the appropriateness of the continued use of the affiliate.
- **A list of broker-dealers with whom the firm has or had revenue sharing agreements for any purpose during the review period.**
 - ✓ Compare the brokerage and execution quality received by such brokers versus other brokers used by the firm.
- **A copy of brokerage allocation reports for a specified period, featuring the name of the broker, aggregate amount of agency commissions by the broker, and aggregate principal values or imputed compensation for principal transactions by the firm.**
 - ✓ Compare the total brokerage amounts allocated to each broker. High allocations of trades could indicate a significant relationship with a particular broker.
 - ✓ If a brokerage budget is prepared, compare total brokerage to this budget. Determine why certain brokers were used more or less than the brokerage target.
- **Procedures adopted pursuant to Rules 10f-3, 17a-7, 17e-1, 12b-1(h), and 12d3-1, and documentation of transactions effected pursuant to these procedures.**
 - ✓ Determine whether such transactions were in accordance with fund objectives.
 - ✓ Ensure that transactions were appropriately reported to and approved by the Board of Directors or Trustees.

2. Trade Allocations

- **A list of all initial public offerings in which clients (including registered and unregistered funds), proprietary accounts, or access persons participated (i.e., purchased shares).**
 - ✓ Determine which clients received shares of the IPO allocation and whether the IPOs were consistent with client investment objectives.
 - ✓ Determine whether certain accounts (e.g., accounts paying an incentive fee) may have been favored.
 - ✓ Determine if proprietary or access person accounts received IPO allocations and whether these allocations were consistent with the firm's disclosures and code of ethics.
 - ✓ Review the net gain or loss on IPOs and determine whether any accounts appeared to receive an inordinate number of "hot" IPOs.
- **Performance returns for each client account for a specified period.**
 - ✓ Compare the performance of accounts with similar objectives to determine if investment opportunities were allocated consistently.
- **A list of shareholders owning 1% or more of Fund shares.**
 - ✓ Review the allocation of investment opportunities among funds and clients to determine if funds substantially owned by insiders received more favorable allocations.

3. Soft Dollars

- **For all soft dollar arrangements, a detailed description of how the product or service is used by the firm.**
 - ✓ Determine to what extent the products or services obtained with soft dollars are research related.
 - ✓ Ascertain whether all or only a select group of clients benefits from the product or service.
 - ✓ Compare the value of the product or service to the level of commissions paid for the product or service.

- **Indicate whether the products or services received by advisers to registered investment companies pursuant to soft dollar arrangements are within the safe harbor provided in Section 28(e) of the Securities Exchange Act of 1934. (Note: Advisers to registered investment companies may violate Section 17(e) of the Investment Company Act of 1940 if they receive products or services pursuant to soft dollar arrangements outside the safe harbor provisions of Section 28(e).)**
 - ✓ If commissions are used to pay for non-research items (i.e., products and services that fall outside the safe harbor), determine whether this is adequately disclosed.
 - ✓ Determine whether any violations of Section 17(e) of the Company Act occurred.
- **Allocation procedures for mixed-use items.**
 - ✓ If a product or service is deemed of mixed-use, determine the appropriateness of the allocation between hard and soft dollars.
- **Provide the approximate annual amount of commissions on securities transactions needed to satisfy each soft dollar arrangement.**
 - ✓ Review the firm's periodic and systematic evaluations of brokerage firms used. Determine whether soft dollar brokers are deemed to provide good execution.
 - ✓ Ascertain whether the firm appears to be forgoing best execution in order to satisfy its soft dollar commitments.
 - ✓ Compare the current level of brokerage sent to the soft dollar brokers to the amount needed to satisfy the commitment.

B. Common Deficiencies

1. Brokerage Arrangements and Execution

- **Inaccurate disclosures**

Examples:

- Firms did not disclose all material conflicts of interest that surround and influence their brokerage arrangements.
- Firms' trading practices were inconsistent with disclosures to clients.

- Firms accepted client directed brokerage accounts without disclosing the effect on their ability to attain best execution for such clients.
- Firms directed trades to affiliated broker-dealers and did not disclose such practices to clients.
- Firms directed cross trades between advisory clients without disclosing such practices to clients.

- **Inadequate policies and procedures**

Examples:

- Firms did not have adequate policies and procedures governing their brokerage arrangements and execution.
- Firms did not periodically and systematically review execution.
- Firms did not document their evaluation to substantiate that they acted in a manner consistent with their fiduciary duty to clients.

- **Compensation for sale of fund shares**

Example:

- Trades were allocated to compensate brokers for their efforts in selling fund shares.

2. Trade Allocations

- **Inadequate policies and procedures**

Examples:

- Firms lacked sufficient policies and procedures to adequately address their trade allocation practices.
- Firms did not implement adequate monitoring and testing procedures to ensure that trade allocations were fair and did not favor or discriminate against any client or account.
- Firms did not follow their allocation policies and procedures consistently and frequently departed from their initial allocation decisions for inappropriate reasons.
- Firms did not document their allocation decisions and reviews.

- **Inappropriate trade allocations**

Examples:

- Certain accounts received preference over others in receiving the most desirable investment opportunities at time of purchase.
- Securities were sold out of favored accounts first to obtain superior prices or secure limited selling opportunities.
- Wrap fee, directed brokerage, and sub-advised accounts were consistently placed at the end of the order-entry queue.
- Profitable trades were allocated to proprietary or favored accounts.

3. *Soft Dollars*

- **Insufficient internal controls**

Examples:

- Firms did not have policies and procedures in place to account for and monitor the amount of soft dollar credits, including allocations made to mixed-use items.
- Firms did not make a good faith determination for the value of research received with soft dollars.
- The receipt and use of soft dollar credits was not documented.

- **Inappropriate use of soft dollars**

Examples:

- Firms' use of soft dollars did not correspond to disclosures to clients.
- Firms did not disclose that they received products and services pursuant to soft dollar arrangements which fall outside the safe harbor provisions of Section 28(e).
- Non-research costs of mixed-use items received pursuant to soft dollar arrangements were not appropriately allocated and were contrary to disclosures provided to clients.

C. Controls to Consider

1. *Brokerage Arrangements and Execution*

- Formalize a process to regularly monitor and evaluate broker performance and execution quality

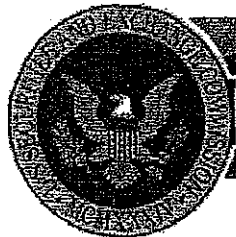
2. *Trade Allocations*

- Regularly compare the performance of like accounts and research outliers. Document these results.

3. *Soft Dollars*

- Track the use of items deemed of mixed-use and allocation of their cost between hard and soft dollars based on actual usage.





Questions Advisers Should Ask While Establishing or Reviewing Their Compliance Programs

May 2006

The Securities and Exchange Commission disclaims responsibility for any private publication or statement of SEC employees or any Commissioner. This outline expresses the staff authors' views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.

This document should not be considered legal advice, and you should consider consulting appropriate legal counsel regarding the federal securities laws. Rather, the questions herein are the views of SEC examination staff. These questions may be used as an aid in creating, evaluating, and maintaining a compliance program, but do not comport to be comments on the requirements of the federal securities laws.

Introduction

Every investment adviser registered with the SEC is required to establish and maintain policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 ("Advisers Act") and rules and regulations related to that Act as well as to detect and correct violations that occur.¹

The compliance policies and procedures should address the practices and risks present at each adviser. No one standard set of policies and procedures will address the requirements established by the Compliance Rule for all advisers because each adviser is different, has different business relationships and affiliations, and, therefore, has different conflicts of interest. Because the facts and circumstances (i.e., risks) that can give rise to violations of the Advisers Act are unique for each adviser, each adviser should identify its unique set of risks, both as the starting point for developing its compliance policies and procedures and as part of its periodic assessment of the continued effectiveness of these policies and procedures. This process of assessing factors that may cause violations of the Advisers Act is often called a "Risk Assessment," a "Gap Analysis," or the compilation of a "Risk Inventory."

Whatever an adviser may call its process for identifying its unique set of compliance risks, it is important that this analysis be conducted while initially establishing compliance policies and procedures and periodically thereafter to make sure that the policies and procedures are sufficiently comprehensive and robust to address all areas in which an adviser is at risk

of violating the Advisers Act.

To assist advisers in conducting their risk assessments, SEC examination staff has compiled the following non-exclusive list of questions.² These questions address a range of activities often present at advisers and point to possible risk areas. Based on each adviser's responses to these questions, the adviser can begin to develop a solid foundation for drafting policies and procedures that are designed to mitigate, manage and control each risk area in ways that reflect the adviser's resources and need for assurance that violations can be prevented or, if violations occur, such violations will be detected promptly and corrected.

A. COMPLIANCE PROGRAMS

(Reference:³ Rules 206(4)-7, 204-2(a))

1. Does your compliance program comply with the requirements of the Compliance Rule?

Risk assessment

2. Have you conducted an effective "risk assessment" (i.e., evaluated how your activities, arrangements, affiliations, client base, service providers, conflicts of interest, and other business factors may cause violations of the Advisers Act or the appearance of impropriety)?
3. Did this risk assessment serve as the basis for developing your compliance policies and procedures?
4. Do you periodically re-evaluate your risk assessment to determine that new, evolving, or resurgent risks are adequately addressed?

Compliance policies and procedures

5. Are your compliance policies and procedures designed to manage and control the compliance risks identified in your risk assessment?
6. Does the implementation of your compliance policies and procedures reflect good principles of management and control?

Quality control and forensic testing

7. Do you regularly conduct transactional or quality control tests to determine whether your activities are consistent with your compliance policies and procedures?
8. Do you conduct periodic tests to detect instances in which your policies and procedures may be circumvented or where there may have been attempts to take advantage of the gaps in your policies and procedures?
9. Do these tests produce exception or other reports? Does knowledgeable staff review these reports, follow up on any exceptions, and resolve problematic items found in a timely manner?

Annual review

10. Have you planned or conducted an annual review of your compliance program? Does or did the review test the comprehensiveness of your compliance policies and procedures, taking into account any changes in your business or organization?
11. Were changes to existing policies and procedures made as a result of the annual review? Are any changes under consideration?
12. Were the findings and results of the annual review brought to the attention of senior management?

Qualities and role of the CCO and other compliance staff

13. Is your CCO knowledgeable regarding the Advisers Act, competent in regard to administering your compliance program, and empowered to enforce compliance with your policies and procedures?
14. Does your compliance staff (including operational staff with compliance responsibilities) approach compliance issues or possible compliance issues with professional skepticism and the incentive and security to ask the hard questions to get to the real issues involved in a matter?
15. When your staff, particularly compliance staff, is confronted with a set of facts and circumstances that is inconsistent with how things should be, does your compliance culture encourage them to follow-up on these matters, including bringing these matters to the attention of higher-level management and the CCO?
16. Does your compliance staff recommend necessary changes to resolve compliance issues? Do they follow-up as needed to ensure that necessary steps are being taken?

Conflicts of interest

17. Does your CCO have both compliance and organizational (operational) positions? Are the resulting conflicts of interest appropriately identified and managed?

Disclosures

18. Do disclosures regarding your compliance program fully and fairly inform clients of your practices?

Information handling

19. With respect to your annual compliance review, is documentation or other output generated to substantiate that you obtained and reviewed all related information in a timely, accurate, and complete manner as pursuant to Rule 204-2(a)(17)(ii)? How do you ensure that this information is preserved and protected from unplanned destruction, loss, alteration, compromise, or use?

B. PROVIDING INVESTMENT ADVICE

(Reference: Sections 204, 204A, 205 and 206, and the rules thereunder)

Information to make decisions

1. Do you maintain current and complete information regarding each client's financial and family circumstances, investment objectives and restrictions, and risk tolerance? Is this information used to provide clients suitable investment advice?
2. What processes, including supervisory procedures, do you have to ensure that the investment advice provided to each client is consistent with (a) the client's circumstances, expectations, restrictions, direction, and risk tolerance, and (b) the information provided to each client in brochures, marketing materials, contracts and otherwise?
3. Are your investment recommendations consistent with the disclosures made to clients? Do your investment recommendations carry a greater or lesser risk than disclosed to clients?
4. If you use an approved list of investments, how do you ensure that actual client investments are consistent with this list?
5. Do you recommend derivative instruments, such as swaps and inverse floaters? Is your client accounting system able to fully accommodate the sometimes unusual terms and conditions relating to these instruments?

Handling non-public information

6. Do you have effective processes to identify, contain, and prevent the unauthorized and/or inappropriate use of non-public information that comes into your possession?
7. If your employees come into possession of non-public information, is this information effectively identified, documented, and contained so that it is used appropriately?
8. If your employees come into possession of non-public information about an issuer as a result of a client's position in that issuer (e.g., a participation in a bank loan), is this information controlled effectively so that it is not used to unlawfully trade in other instruments of the issuer (e.g., shorting the issuer's equity if the issuer's financial condition deteriorates)?

Conflicts of interest

9. If you provide investment advice to clients regarding companies with which you have business relationships, do you have processes to prevent providing conflicted investment advice to clients and to ensure that clients receive full and fair disclosures regarding these conflicts?

10. Do you engage in "window dressing" (i.e., are decisions to effect trades in client or proprietary accounts undertaken in an attempt to manipulate the closing price of a security or to be able to present to clients a list of portfolio positions that is consistent with their investment objectives but which is substantially different than the positions held in between reporting periods)?
11. How do you deal with conflicts in advice you give to clients (e.g., advising one client to sell a thinly traded security, while at the same time recommending that another client purchase the same security)?
12. Is portfolio turnover (frequency and amount of trading in clients' accounts) consistent with clients' investment objectives, or is it the result of decisions by employees to generate commission credits that you can use for your own purposes?
13. If you participate in soft dollar arrangements (or other arrangements dependent on the receipt of clients' business or use of clients' assets), are the sources and types of information or products and services obtained or used consistent with disclosures made to clients and with your fiduciary relationship with clients?
14. How do you prevent cherry-picking of favorable trades on behalf of favored clients or proprietary accounts? Are changes in order allocations consistent with your fiduciary relationship with clients, code of ethics, and disclosures?
15. How do you prevent scalping of investment advice provided to clients (i.e., the illegal practice of recommending that clients purchase a security and secretly selling the same security in a personal or proprietary account contrary to the recommendation)?
16. Do you have any side letters or agreements with any participant in a pooled vehicle you advise or manage? Are the terms and conditions of these agreements consistent with your disclosures to clients and fiduciary relationship with clients and pooled vehicle participants?
17. Do you vote proxies consistent with your proxy voting policies and procedures, disclosures to clients, and status as a fiduciary?

Advisory fees

18. Are advisory fees, including any incentive compensation or other fees, calculated and charged in accordance with contractual arrangements and disclosures?
19. Do clients that pay performance fees meet the requirements established in Section 205?
20. If a client terminates its advisory relationship, are the clients reimbursed fees calculated and paid in advance in accordance with contractual terms and disclosures?

Disclosures

21. Are disclosures made to clients consistent with your actual practices? Are those disclosures reviewed regularly to determine whether they remain current?
22. If you made material changes to your disclosures, have you conveyed such information to clients?

Information handling

23. How do you ensure that your compliance policies and procedures are adequate with respect to the investment advice you provide?
24. Is documentation or other output generated to substantiate that you obtained all information related to providing investment advice in a timely, accurate, and complete manner? Do you ensure that this information is preserved for the required period of time and protected from unplanned destruction, loss, alteration, compromise, or use?

C. BROKERAGE ARRANGEMENTS AND TRADE EXECUTIONS

(Reference: Section 206; Regulation SHO, and Regulation M under the Securities Exchange Act of 1934, Banking Regulation Regulation T)

Seeking best execution

1. Do you have policies and procedures in place designed to seek best execution of clients' orders and that are consistent with client disclosures?
2. Do you periodically evaluate your arrangements with broker-dealers to determine that those broker-dealers continue to provide best execution of clients' orders? Are clients' orders consistently placed with broker-dealers that are likely to provide best execution?
3. Based on post-trade analyses of client order execution, are the full costs incurred by clients (market impact, opportunity, spreads, and commissions) consistent with your duty to seek best execution, disclosures regarding your practices in placing orders, and your status as a fiduciary?

Regulatory issues

4. Are trades placed in ways that are consistent with all marketplace regulations in the jurisdictions in which trading takes place?
5. Are short sale trades placed consistently with applicable regulations such as Regulation SHO and Regulation M? Are appropriate levels of initial and maintenance margin maintained as required by Regulation T?

Conflicts of interest

6. If you are also registered as a broker-dealer or futures commission merchant ("FCM") or are affiliated with or have a proprietary

relationship with a broker-dealer or FCM, are the terms and conditions of clients' orders placed through such entities consistent with your fiduciary relationship and disclosures made to clients?

7. If trades are placed on a principal basis, are these trades consistent with the requirements of Section 206-3?
8. If trades are placed on an agency cross basis, are these trades consistent with the requirements of Section 206(3) and Rule 206(3)-2 thereunder?
9. Are trade errors identified at the earliest possible time and resolved in a manner that is consistent with disclosures made to clients and your fiduciary relationship with clients?
10. Given your current policies and procedures, is there a high probability that clearly erroneous trades or trades with "intent to defraud" will be identified and prevented from being communicated to broker-dealers for execution?

Forensic test

11. Do you periodically compare brokerage commissions paid to executing broker-dealers with the value of products and services (i.e., research) you and clients have obtained from these broker-dealers? Are the outcomes consistent with your disclosures and status as a fiduciary?

Disclosures

12. Do you disclose material issues that may impact your decision to maintain your brokerage arrangements and place clients' orders? Are these disclosures consistent with your actual practices?

Information handling

13. With respect to brokerage arrangements and the placing of clients' orders (including each subsequent modification, addition, or cancellation of an order), is documentation or other output generated to substantiate that information was obtained and reviewed in a timely, accurate, and complete manner? How do you ensure that this information is preserved and protected from unplanned destruction, loss, alteration, compromise, or use?

D. ALLOCATING INVESTMENT OPPORTUNITIES AMONG CLIENTS

(Reference: Section 206)

Fairness among clients

1. Are allocations of limited investment opportunities (e.g., hot IPOs) dispersed among clients in ways that fairly reflect clients' investment objectives and restrictions, disclosures made to clients, and your fiduciary relationship with clients?

2. Are allocations among clients of positions acquired in blocked or bunched trades consistent with disclosures and your fiduciary relationship with clients?
3. Are proprietary accounts' and access persons' participation in investment opportunities, including blocked or bunched trades, consistent with your code of ethics, and disclosures made to clients? Also, are any staff issued interpretive guidance, such as no-action letters, applicable?
4. When changes are made to the initial decisions regarding the allocation of trades among client, proprietary, and/or access persons' accounts, are these changes supported by fully documented and approved audit trails?
5. If the allocation of block orders among clients or proprietary accounts is determined at any time after an order is placed for execution, is the allocation, including the selection of accounts to participate in such trades, consistent with disclosures and your status as a fiduciary?

Forensic test

6. Do you periodically evaluate the extent to which each client actually participated in limited investment opportunities, taking into account your trade allocation policies, disclosures, and status as a fiduciary?
7. Over relevant periods of time, is the performance among client accounts consistent with what would be expected if investment opportunities were allocated fairly and equitably among all eligible clients?

Disclosures

8. Are disclosures regarding trade allocation policies and procedures, including possible exceptions to the use of these policies and procedures, consistent with your actual practices?
9. Do disclosures of trade allocation policies and procedures, including possible exceptions to the use of these policies and procedures, fully and fairly inform clients of your practices and enable clients to give their informed consent to all material conflicts of interest that may arise?

Information handling

10. With respect to the allocation of investment decisions among clients, is documentation or other output generated to substantiate that you obtained and reviewed all related information in a timely, accurate, and complete manner? Do you ensure that this information is preserved for the required period of time and protected from unplanned destruction, loss, alteration, compromise, or use?

E. CODE OF ETHICS AND PERSONAL TRADING

(Reference: Rule 204A-1, Section 206)

Code provisions

1. Does your code of ethics encourage an honest, open, and ethical compliance culture/ethical environment?
2. Is your compliance culture/ethical environment consistent with the description in your code of ethics?
3. Do you use specific factors (e.g., the number of compliance issues that occur) to measure the effectiveness of the ethical environment?
4. Does your compliance culture handle conflicts of interest and compliance issues in ways that are consistent with your disclosures, given your fiduciary responsibilities?
5. Is periodic training provided to your staff that effectively provides information with respect to expectations regarding ethical conduct?
6. Is your process for designating "supervised persons" consistent with the definition of such persons in Rule 204A-1 as well as the organization of your firm?
7. Is your process for designating "access persons" consistent with the definition of such persons in Rule 204A-1 and encompass those people associated with your firm that have, or may have, knowledge or access to information regarding the advice provided to clients?
8. For all access persons, do you obtain written annual acknowledgement regarding their knowledge of your code of ethics?
9. Do the provisions of your code of ethics comply with the requirements described in Rule 204A-1 regarding pre-clearance and reporting of certain access persons' trades and access persons' transaction and holdings reports?
10. If your code of ethics is more restrictive than Rule 204A-1 regarding pre-clearance and transaction reporting do you ensure that access persons adhere to your code of ethics?
11. Is the information contained in periodic reports of trading and annual holdings reports used to effectively monitor personal trading activities of access persons?
12. Are violations of the code of ethics handled appropriately and consistently across all staff, including the imposition of fines or similar sanctions for repeated violations of code provisions?
13. Is the CCO, or another designated person, responsible for administering your code of ethics? If another designated person is responsible, does this individual report directly to the CCO or upper management of your firm, in general, and with respect to the code of ethics?

Trading by insiders

14. Are personal trades and holdings of access persons, including proprietary trades and holdings, consistent with your code of ethics, disclosures to clients, and your fiduciary relationship with clients?

Forensic tests

15. Is the performance of access persons' accounts and proprietary accounts consistent with the performance of client accounts (taking into account differences in objectives, restrictions, and amount of risk taken)? Is it consistent with your code of ethics and other disclosures made to clients?
16. Are there strong information barriers between you and affiliates regarding advice given to clients? If not, is the performance of these affiliates' proprietary accounts consistent with the performance of client accounts (taking into account differences in objectives, restrictions and amount of risk taken)? Is it consistent your code of ethics and other disclosures made to clients?

Conflicts of interest

17. Are gifts and entertainment provided by actual or potential service providers and/or broker-dealers (whether or not currently used to execute client transactions) and accepted by your officers, directors, and employees consistent with the code of ethics and disclosures made to clients?
18. Are gifts and entertainment offered to third parties by your officers, directors and employees consistent with your fiduciary relationship with clients?
19. Are business arrangements with third parties that impact the services you provide to clients (e.g., the negotiation of loans from bank custodians you recommend for client use) consistent with disclosures and your fiduciary relationship with clients?

Registration status

20. In light of the amount of assets under management and the other types of advisory services you offer, are you appropriately registered with the SEC?
21. Are all advisory representatives that have direct client contact appropriately registered with the state(s) in which each representative conducts advisory business in accordance with applicable state law?

Information handling

22. With respect to the operation of your code of ethics, is documentation or other output generated to substantiate that you obtained all related information in a timely, accurate, and complete manner? Do

you ensure that this information is preserved for the required period of time and protected from unplanned destruction, loss, alteration, compromise, or use?

F. VALUATION OF CLIENTS' POSITIONS

(Reference: Section 206)

Accuracy of prices used

1. Do you perform adequate and on-going due diligence on the methodologies used by all entities, such as pricing services, that provide pricing information used to value clients' positions?
2. Do the prices used to value clients' positions consistently reflect the price(s) that would be paid or received in a transaction with a knowledgeable and willing counter party at the time the pricing was performed?
3. Are the prices used to value clients' holdings based on the appropriate quantities of each position (i.e., match the quantities of each position as reported by the client's custodian)?
4. Do other assets (e.g., cash, receivables and prepaid items) and liabilities (e.g., payables) used in determining the gross and net value of clients' accounts consistently reflect the current value of these items at the time of the calculation?
5. If you manage a pooled investment vehicle and move positions into a "side pocket," is the value applied to those positions consistent with your pricing policies and procedures?
6. If an error is made when calculating the gross or net value of clients' positions or the net asset value ("NAV") of pooled accounts, is the error corrected in a way that is consistent with disclosures and your fiduciary relationship with clients?
7. Is your process for calculating the NAV of pooled clients' accounts and allocating the NAV of pooled vehicles among participants consistent with the pooled vehicles' policies, disclosures, and your fiduciary relationship with clients?

Corporate actions

8. Do your (or a service provider's) procedures for identifying and recording corporate actions, such as dividends and stock splits that impact clients' positions, timely and accurately capture these actions?
9. Do your (or a service provider's) procedures for monitoring pending corporate actions ensure that appropriate follow-up is taken so that stale receivable items, such as recapture of taxes withheld, do not accumulate in clients' accounts?
10. Are your (or a service provider's) policies and procedures for following-up and causing clients to participate in class action

settlement funds consistent with your disclosures and fiduciary relationships with clients?

Forensic test

11. Taking into account the volume and timing of transactions in pooled vehicles that you advise, do the valuations that make up the NAV fairly represent each participant's ownership interest?

Disclosures

12. Are your clients fully and fairly informed of your process for valuing clients' positions, including possible exceptions? Are they able to give their informed consent to all material conflicts of interest that arise from such processes?

Information handling

13. With respect to your pricing and valuation process, including the calculation of NAV for pooled vehicles, is documentation or other output generated to substantiate that you obtained all related information in a timely, accurate, and complete manner? Do you ensure that this information is preserved for the required period of time and protected from unplanned destruction, loss, alteration, compromise, or use?

G. SAFEGUARDING CLIENTS' ASSETS

(Reference: Rule 206(4)-2, Regulation S-P under the Gramm-Leach-Bliley Act)

Custody practices

1. Are client assets held in accounts maintained by qualified custodians as required by Rule 206(4)-2?
2. If you inadvertently obtain possession of clients' assets (e.g., if a client sends you stock certificates), are required actions taken within the time periods specified in Rule 206(4)-2 to dispose of those assets?
3. Does the custodian of each client's account independently monitor corporate actions (e.g., stock splits, dividends) affecting the account?
4. Does the custodian of each client's account independently determine the value of each position on a date near the date of each statement sent to the client and communicate such valuations and the total value of the account in its statements sent to clients?
5. Are securities lending practices that involve loans of clients' securities consistent with clients' contracts and disclosures made to clients?

Providing information to clients

6. Do all clients receive periodic statements directly from their qualified custodians, and do these statements describe all activity in their accounts? Are these statements accurate (i.e., fully and fairly reflect transactions in and balances of each account during the periods covered by the statements)? If not, is the information contained in account statements provided to clients regularly verified by a knowledgeable person that has no access to clients' assets to determine the truthfulness of transactional, balance and performance information?
7. If you are the only source of information provided to clients regarding activity in and balances of their accounts (i.e., no custodial statements are sent to clients), are those accounts subject to annual, unannounced surprise audits by an independent auditor? Do those audits include confirmation of account activity and balances directly with clients?
8. If one or more client's account holdings are subject to a surprise audit, does the auditor file the results of its audit with the SEC on Form ADV-E?

Forensic tests

9. Do you periodically verify the postal/e-mail addresses to which clients' account statements are sent (both by you and client custodians)?
10. Do you regularly reconcile account balances and transaction detail shown on your records with information reported by clients' custodians? Is there follow-up to resolve all reconciling items?
11. Are pooled vehicles over whose assets you have custody annually audited by an independent auditor in accordance with generally accepted accounting principles?
12. Does the auditor performing the financial statement audit of each pooled vehicle confirm with all participants in the pool the activity in and balances of their account and appropriately follow-up on any discrepancies identified (not a specific requirement)?
13. Does the auditor send a copy of the pooled vehicles' audited financial statements directly to each participant in the pooled vehicle or to a representative of the participant (not a specific requirement)?

Conflicts of interest

14. Do you or your advisory representatives maintain business or personal relationships with clients' custodians? Do you personally benefit in some way from clients' relationships with those custodians (e.g., borrowing at below market rates)? If you or your advisory representatives benefit, do you disclose this to clients and/or have you established policies and procedures to mitigate any perceived risks?

Disclosures

15. Are clients fully and fairly informed of your practices for safeguarding clients' assets, including possible exceptions to these practices, and able to give their informed consent to all material conflicts of interest that arise from such practices?

Information handling

16. With respect to custody or safekeeping for each client asset and liability, is documentation or other output generated to substantiate that you obtained all related information in a timely, accurate, and complete manner? Do you ensure that this information is preserved for the required period of time and protected from unplanned destruction, loss, alteration, compromise, or use?

H. MARKETING AND PERFORMANCE ADVERTISING

(Reference: Rules 206(4)-1 and 206(4)-3)

Truthfulness of representations

1. Are all "communications with clients" (i.e., representations made and numbers used in advertisements, responses to requests for proposals, in other marketing literature and on web sites maintained by you or to which you maintain links) truthful, representative, complete, and not misleading?
2. Is information about past specific performance of investment advice that is contained in communications with clients and other investors consistent with Rule 206(4)-1, and your status as a fiduciary? Also, are any staff issued interpretive guidance, such as no-action letters, applicable?
3. Are model and composite performance figures, formulas, and related disclosures contained in communications to clients consistent with your status as a fiduciary? Also, are any staff issued interpretive guidance, such as no-action letters, applicable?
4. Are representations that composite performance shown in communications with clients is presented in conformity with a specified industry standard consistent with the requirements of that standard?
5. Are advertisements that must be cleared by the NASD before use or filed with the NASD after use done so on a timely basis?
6. Are all communications with clients provided by advisory representatives reviewed and cleared as required by your policies and the law?

Use of solicitors

7. Is your use of third party solicitors consistent with Rule 206(4)-3?
8. Do the disclosure documents used by third party solicitors comply

with the requirements of Rule 206(4)-3 and your status as a fiduciary?

9. Are all payments made to third party solicitors or other compensation arrangements maintained with solicitors consistent with disclosures and your status as a fiduciary?
10. Are the solicitors used by pooled vehicles that you manage or advise required to be registered representatives of a broker-dealer (as a result of the form of compensation they received for their work) and, if so, are they appropriately registered?
11. Is the compensation received by solicitors used by pooled vehicles that you manage or advise and the relationships between you and these solicitors fully and fairly disclosed to investors and consistent with your status as a fiduciary?
12. Are advisory clients referred to you by broker-dealers fully and fairly informed of the conflicts of interest you face in placing trades for their accounts and negotiating commission rates (e.g., if you do not negotiate commission rates paid on trades placed for clients referred by broker-dealers, and the commissions paid by such clients are higher than rates paid other clients for whom you do negotiate commission rates)?

Disclosures

13. Are your marketing and performance advertising practices fully and fairly disclosed to clients, and are clients enabled to give their informed consent to all material conflicts of interest that arise from such policies and procedures?

Information handling

14. With respect to performance advertising, is all required documentation or other output generated to substantiate that you obtained all related information in a timely, accurate, and complete manner maintained pursuant to Rule 204-2(a)(16)? Do you ensure that this information is preserved for the required period of time and protected from unplanned destruction, loss, alteration, compromise, or use?

I. CREATING, RECORDING, RETAINING AND REPORTING INFORMATION

(Reference: Rule 204-2)

Information handling

1. Do you create, record, and retain all required information, including information that may be contained in e-mails and instant messages, for required periods? Is this information accurate and current as required by Rule 204-2?

2. Can you promptly produce information, whether on paper or electronic media, upon request?
3. Do you maintain the means to or does your records management program enable you to read and produce information maintained electronically or photographically or that has been encrypted for the entire period required by record retention rules (taking into account changes in software needed to access the information)?
4. Does your records management program provide for the destruction of records after the required retention periods have passed? Is the destruction automatic, or can it be suspended (e.g., when the possibility of an inspection or litigation arises)?
5. Do you ensure that all information that is deleted from files or otherwise disposed of is either not required to be kept or is beyond any required retention period?
6. Do you effectively safeguard information you are required to maintain from unauthorized access, alteration, loss, or destruction?
7. Do you have security measures to properly safeguard personal and financial information of clients, including consumer credit report information, from unauthorized access, disclosure or use? Do you ensure that the security measures of your service providers also safeguard this information?

Malicious intrusions

8. Do your electronic information systems, both internal and those supplied by third parties, effectively detect and prevent malicious intrusions from internal and external sources? Do you have effective oversight measures to protect your electronic infrastructure, operating systems, files and databases?

Disclosures and filings

9. Do you periodically provide clients with privacy policy notices, as required?
10. Are required filings (e.g., updates of Form ADV, Parts 1 and II; Form ADV-E and Form 13F) accurately and completely prepared and filed on a timely basis?
11. Do disclosures provided to clients fully and fairly describe all material conflicts of interest that you face when providing investment advice?
12. Are all required reports and information (e.g., annual offer of disclosure document) prepared accurately, completely, timely, and consistent with applicable regulations?
13. Have you reported to clients information required by Rule 206(4)-4 (e.g., an adverse financial condition or certain disciplinary events)?
14. Are complaints and concerns that you receive (either from clients or

from sources that impact clients) reviewed by a person(s) that has no access to clients' assets and that is in a position to effectively act on the information?

15. With respect to the collection and retention of information, is documentation or other output generated to substantiate that you obtained all related information in a timely, accurate, and complete manner? Do you ensure that this information is preserved for the required period of time and protect it from unplanned destruction, loss, alteration, compromise, or use?

J. ANTI-MONEY LAUNDERING PROGRAM

(Reference: For information about possible anti-money laundering ("AML") requirements for advisers please see www.fincen.gov.)

1. Does your AML program contain all of the elements required by applicable regulations?
2. Do you ensure that your staff has sufficient knowledge and skills to effectively carry out their AML responsibilities?
3. Does your AML program appear to be effective in identifying suspicious cash/ currency activity and reporting such activities to appropriate authorities?
4. With respect to your AML program, is documentation or other output generated to substantiate that you obtained all related information in a timely, accurate, and complete manner? Do you ensure that this information is preserved for the required period of time and protected from unplanned destruction, loss, alteration, compromise, or use?
5. Do you comply with the U.S. Treasury Office of Foreign Asset Control's ("OFAC") requirements by restricting your business transactions with certain individuals, entities, and/or countries on lists compiled by OFAC?

¹ See, Rule 206(4)-7 ("Compliance Rule") under the Advisers Act. The Compliance Rule also requires advisers to no less frequently than annually review the operation of their policies and procedures to ensure their continued effectiveness in preventing, detecting and correcting compliance problems and to designate a Chief Compliance Office ("CCO") to administer their compliance program. See also, Advisers Act Release No. 2204, Dec. 17, 2003, available at <http://www.sec.gov/rules/final/ia-2204.htm>.

² All references herein to 'you' and 'your' refer specifically to the adviser.

³ Unless otherwise specified, all sections and rules referenced in this document are related to the Advisers Act. In addition to the text contained in the sections and rules, you may find it useful to read releases adopting, interpreting, and/or amending such rules. The referenced sections and rules contained in this document are not all-inclusive.

http://www.sec.gov/info/cco/adviser_compliance_faq.htm

[Home](#) | [Previous Page](#)

Modified: 09/15/2006



**Notice I-08-04**

February 01, 2008

Annual Regulatory Reminder for Commodity Pool Operators

National Futures Association has always been committed to providing our Members with the resources they need to meet their regulatory obligations as efficiently as possible. During some of our recent audits, NFA Members have suggested that we provide them with an annual reminder regarding certain requirements that are not part of their day-to-day operations. Responding to this request, NFA is pleased to send you this email listing certain requirements you have for the upcoming year. This list does not capture all of your responsibilities, but it should help remind you of certain non-routine requirements.

Within the next 12 months you will be required to:

1. Complete the Annual Registration Update and Questionnaire on NFA's Web site and pay your NFA dues on the anniversary date of your firm's registration. Failure to satisfy all the requirements in the annual update process within 30 days of your anniversary date will result in the withdrawal of your firm's NFA registration and/or Membership. Carefully check your registration record including address, contact information, and listed principals. Ensure any individual in a line of supervisory authority over Associated Persons ("APs") is also registered as an AP. For additional information on who has to register as an AP, see NFA's Notice to Members I-07-38 at <http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=1963>.
2. Complete NFA's Self-Examination Checklist located on NFA's Web site at <http://www.nfa.futures.org/compliance/selfexam.asp>.
3. Send your firm's Privacy Policy to every current participant (in addition to every new participant when the participant invests in a fund). For guidance in preparing your policy, please consult NFA's Privacy Policy questionnaire (Appendix D of the Self-Exam Checklist).
4. Test your Disaster Recovery Plan and make any necessary adjustments. For guidance in preparing your plan, please consult NFA's Business Continuity and Disaster Recovery Plan questionnaire (Appendix B of the Self-Exam Checklist).
5. Provide Ethics Training as outlined in your firm's written Ethics Training Procedures. For guidance in developing your procedure, please consult NFA's Ethics Training Policy questionnaire (Appendix C of the Self-Exam Checklist).
6. File any new exemption notices electronically through NFA's EasyFile system.
7. If soliciting new pool participants, distribute a Disclosure Document that is no more than 9 months old and that has been reviewed by NFA.
8. Submit to NFA through NFA's EasyFile system, and distribute to current participants, a certified Annual Report for each pool as of the close of the pool's fiscal year. CFTC Regulations require Commodity Pool Operators to follow strict deadlines and filing requirements, and failing to meet those deadlines may result

in a disciplinary action against a CPO. To learn more about EasyFile, go to NFA's Web site and access the seminar at <http://www.nfa.futures.org/member/indexArchive.asp>.

Since NFA acts as the CFTC's delegate when NFA receives and reviews Annual Reports, the reports are subject to requests under FOIA. CPOs may request confidential treatment of Annual Reports but must strictly follow the CFTC procedures contained in CFTC Regulation 145.9 for filing such requests. For information on how to request confidential treatment of Annual Reports filed with NFA, consult the information on NFA's Web site at http://www.nfa.futures.org/compliance/CPO_confidentialTreatmentRequests.asp.

When preparing pool Annual Reports, refer to the CFTC's annual letter for useful tips. This letter can be found at <http://www.cftc.gov/industryoversight/intermediaries/guidancecporeports.html>.

We recommend that you keep this email as a reference guide to ensure that all requirements are completed on time throughout the year. As always, if you need assistance with these or any other NFA requirements, please contact NFA's Information Center at (800) 621-3570.

©2003-2008 National Futures Association



**Notice I-08-05**

February 01, 2008

Annual Regulatory Reminder for Commodity Trading Advisors

National Futures Association has always been committed to providing our Members with the resources they need to meet their regulatory obligations as efficiently as possible. During some of our recent audits, NFA Members have suggested that we provide them with an annual reminder regarding certain requirements that are not part of their day-to-day operations. Responding to this request, NFA is pleased to send you this email listing certain requirements you have for the upcoming year. This list does not capture all of your responsibilities, but it should help remind you of certain non-routine requirements.

Within the next 12 months you will be required to:

1. Complete the Annual Registration Update and Questionnaire on NFA's Web site and pay your NFA dues on the anniversary date of your firm's registration. Failure to satisfy all the requirements in the annual update process within 30 days of your anniversary date will result in the withdrawal of your firm's NFA registration and/or Membership. Carefully check your registration record including address, contact information, and listed principals. Ensure any individual in a line of supervisory authority over Associated Persons ("APs") is also registered as an AP. For additional information on who has to register as an AP, see NFA's Notice to Members I-07-38 at <http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=1963>.
2. Complete NFA's Self-Examination Checklist located on NFA's Web site at <http://www.nfa.futures.org/compliance/selfexam.asp>.
3. Send your firm's Privacy Policy to every current client (in addition to sending it to every new client when the client enters into an advisory agreement or purchases a subscription). For guidance in preparing your policy, please consult NFA's Privacy Policy questionnaire (Appendix D of the Self-Exam Checklist).
4. Test your Disaster Recovery Plan and make any necessary adjustments. For guidance in preparing your plan, please consult NFA's Business Continuity and Disaster Recovery Plan questionnaire (Appendix B of the Self-Exam Checklist).
5. Provide Ethics Training as outlined in your firm's written Ethics Training Procedures. For guidance in developing your procedure, please consult NFA's Ethics Training Policy questionnaire (Appendix C of the Self-Exam Checklist).
6. File any new exemption notices electronically through NFA's EasyFile system.
7. If soliciting new clients, distribute a Disclosure Document that is no more than 9 months old and that has been reviewed by NFA.
8. If placing bunched orders, analyze each trading program at least quarterly to ensure that the order allocation method has been fair and equitable and document this analysis.

We recommend that you keep this email as a reference guide to ensure that all requirements are completed on time throughout the year. As always, if you need assistance with these or any other NFA requirements, please contact NFA's Information Center at (800) 621-3570.

©2003-2008 National Futures Association





Office of Compliance Inspections and Examinations¹ Investment Adviser Examinations: Core Initial Request for Information

November 2008

The content of our initial request for information reflects the nature and extent of an adviser's business. For an adviser that provides only traditional money management services to non-fund clients, our initial request for information reflects the core services and related controls that typically exist in that environment. If an adviser's business has other features, the information initially requested will include both the core set of information described below and additional information that will allow the examination staff to evaluate compliance activities for these additional activities and relationships. Some of these additional activities and relationships include sponsoring a family of registered investment companies, sponsoring one or more privately offered funds, participating in PIPES offerings, participating in a separately managed account (wrap-fee) program, being also registered as a broker-dealer and being a manager of managers.

Background Regarding Requested Information

Each investment adviser registered with the Commission is required to adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 (the "Advisers Act"), to review those policies and procedures at least annually for their adequacy and the effectiveness of their implementation, and to designate a chief compliance officer who is responsible for administering the policies and procedures (the "Compliance Rule" provisions are located in Rule 206 (4)-7 under Advisers Act). The Compliance Rule is designed to protect investors by mandating that all advisers have internal programs to promote compliance with the Advisers Act. Each adviser should adopt policies and procedures that take into consideration the nature of that firm's operations. The policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred.

The initial phase of an examination includes a review of the firm's business and investment activities, its organizational affiliations and its corresponding compliance policies and procedures. The staff will request information and documents and speak with the firm's employees to ensure an understanding of the firm's business and investment activities and the operation of its compliance program. Using the information obtained, the staff will assess whether the firm's compliance policies and procedures appear to effectively address the firm's compliance risks. This work includes testing the firm's compliance program in particular areas.

The following points provide an overview of the core information the staff requests:

- Certain general information to provide an understanding of the firm's business and investment activities, including organizational charts, demographic and other data regarding advisory clients, and a record of all trades placed for its clients (trade blotter).
- Information about the compliance risks that the firm has identified (e.g., an inventory of compliance risks) and the written policies and procedures the firm has established and implemented to address each of those risks to provide an understanding of the firm's compliance risks and corresponding controls.
- Documents relating to the results of and output from the various transactional (quality control) and period (forensic) testing conducted to provide an understanding of how effectively a firm has implemented its compliance policies and procedures. This includes the results of any compliance reviews, quality control analyses, surveillance, forensic or transactional tests the firm has used to determine if activities have been performed as expected and to identify activities or transactions that have fallen short of or breached related policies and procedures.
- Information regarding the results of any tests and follow-up actions taken by the firm to address shortfalls or breaches revealed by such tests to provide an understanding of steps taken by the firm to address the results of compliance reviews, quality control, forensic or transactional tests conducted. This information might include, for example, warnings to or disciplinary action of employees, changes in policies or procedures, redress to affected clients, or other measures.
- Information to perform testing for compliance in various areas.

Core Initial Information Examiners Request

Described below are the types of core information that examiners will request during a routine examination of a typical money manager that does not engage in additional activities and/or have additional relationships. Also, for some of the items, a copy (either electronic or hard copy) may be requested, while examiners may only request access to other items.

General Information

- Organizational structure, affiliations, and control persons.
- Current and former officers and/or directors.
- Standard client advisory contracts or agreements.
- Sub-advisory agreements executed with other investment advisers.
- Fees and payments for services rendered.

- Power of attorney obtained from clients.
- Joint ventures or other businesses (with respect to the firm or any officer, director, portfolio manager, or trader).
- Disclosure documents and filings with regulators.
- Service providers and the services they perform.
- Remedial actions taken against supervised persons.
- Threatened, pending and settled litigation or arbitration involving the Adviser or any supervised person.

Information Regarding the Compliance Program, Risk Management and Internal Controls

- Compliance Program
 - Compliance policies and procedures in effect during the examination period.
 - Tests performed (i.e., compliance reviews, quality control analyses, surveillance, and/or forensic or transactional tests performed by the firm).
- On-going Risk Identification and Assessment
 - Inventory of compliance risks that forms the basis for policies and procedures and notations regarding changes made to the inventory.
 - Documents mapping the inventory of risks to written policies and procedures.
 - Written guidance provided to employees regarding compliance risk assessment process and procedures to mitigate and manage compliance risks.
- Internal audit review schedules and completed audits.
- Remote office and/or independent advisory contractor oversight process.
- Client complaints and correspondence and the process for monitoring such communications.
- Annual and/or interim reviews of policies and procedures, including interim reports.
- Record of non-compliance with the Code of Ethics.

- Valuation
 - Pricing services, quotation services, and externally-acquired portfolio accounting systems used in the valuation process and payment information.
 - Fair-valued and illiquid securities held by clients.
 - Advisory fee calculations.
- Information Processing, Reporting, and Protection
 - Regulation S-P guidance.
 - Controls of employee access to physical locations containing customer information.
 - Electronic access controls.
 - Business continuity plan.

Information to Facilitate Testing with Respect to Advisory Trading Activities

- Trade blotter.
- Advisory Information for Individual Clients
 - Current advisory client information regarding: account inception, type, balance, and management discretion; affiliation with the firm; custodial arrangements; account statement delivery; firm trading authority; services provided; investment strategy; portfolio manager; participation in composites; brokerage arrangements; fee computation; fee payment arrangements; and consultant related to obtaining the client, if any.
 - Advisory clients lost during review period.
- Portfolio Management
 - Securities held in all client portfolios, including information identifying each client holding an interest, the amount owned by each client, the aggregate number of shares or principal and/or notional amount held and total market value of the position.
 - Investment and/or portfolio management committee meetings and minutes, if held and maintained.
 - Publicly traded companies for which employees of the Adviser or its affiliates serve as officers and/or directors.
 - Companies for which employees of the adviser or its affiliates

serve on creditors' committees.

o Most profitable and least profitable investment decisions.

- Brokerage Arrangements

- o Brokerage arrangements and best execution evaluation documentation.

- o Soft dollar budget and products and services obtained using clients' brokerage commissions.

- o Commission-sharing arrangements.

- o Affiliated broker-dealers.

- o Securities in which the Adviser or an affiliate was a market maker.

- o Securities purchased for clients in which the firm or an affiliate underwrote or participated as underwriting manager, purchase group, and/or syndicate or selling group.

- o Trade errors and related information.

- Trade allocation information regarding initial public offerings and secondary offerings in which clients, proprietary accounts or access persons participated.

- Conflicts of Interest and/or Insider Trading

- o Code of Ethics and insider trading policies and procedures for firm and affiliates.

- o Exemptions from Code of Ethics for supervised persons.

- o Personal trading policies and procedures of contract employees and temporary employees.

- o Reports of securities transactions reported by access persons.

- o Non-public information control and monitoring procedures.

- o Fee splitting or revenue sharing arrangements.

Information to Perform Testing for Compliance in Various Areas

- Performance Advertising and/or Marketing

- o Pitch books, one-on-one presentations, pamphlets, brochures, and other promotional and/or marketing materials used for each investment strategy and/or mandate.

- Advertisements used to inform or solicit clients.
- Website access, if restricted.
- Composite performance returns.
- Accounts included in each composite and specific client account performance and supporting documentation for such clients.
- Accounts not included in a composite.
- Terminated composites.
- Persons paying and compensation received for referring clients.
- Third-party solicitor agreements, correspondence, compensation paid, and separate disclosure document.
- Requests for proposals.
- Third-party consultant questionnaires.
- Global Investment Performance Standards compliance documentation.
- Financial Records
 - Balance sheet, trial balance, income statement, and cash flow statements.
 - Cash receipts and disbursements journal.
 - General ledger and chart of accounts.
 - Loans and sales of firm or affiliate's stock.
- Custody
 - Custodial confirmation that account statements are sent directly to clients.
 - Custodial confirmation of positions for specific clients.
- Anti-Money Laundering
 - Office of Foreign Assets Control ("OFAC") policies and procedures.
 - Internal Revenue Code ("IRC") and Bank Secrecy Act ("BSA") reporting procedures.

¹ The Securities and Exchange Commission, as a matter of policy, disclaims

responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the staff of the Office of Compliance Inspections and Examinations and do not necessarily reflect the views of the Commission or the other staff members of the SEC. Examinations indicating deficiencies generally result in (non-public) deficiency letters requesting that the firm take corrective action. Serious deficiencies may be referred to the SEC's enforcement staff.

<http://www.sec.gov/info/cco/requestlistcore1108.htm>

[Home](#) | [Previous Page](#)

Modified: 11/13/2008