2008 CCOutreach Regional Seminars

Top Deficiencies Identified in Examinations

This document, prepared by the staff of the Office of Compliance Inspections and Examinations, is intended to provide investment adviser Chief Compliance Officers, including investment advisers managing investment companies, with examples of top deficiencies identified in examinations conducted during the 2007 fiscal year.

Deficiencies in the following strategic risk areas were cited in more than 10% of our examinations:

- *Compliance Rule;*
- *Information Processing and Protection;*
- *Performance Advertising and Marketing;*
- *Personal Trading;*
- *Brokerage Arrangements and Execution;*
- *Information Disclosures, Reporting and Filings; and*
- *Portfolio Management.*

The examples provided for each of these strategic risk areas include the most common deficiencies in examinations conducted during the 2007 fiscal year. These deficiencies are not provided in any particular order. For example, they are not ranked by frequency or severity. Rather, they are provided to shed some light on the deficiencies that examiners frequently cite.

This document also includes various effective compliance controls examiners have observed at firms that may serve to mitigate or manage these deficient practices noted. CCOs may want to consider these internal controls when evaluating the effectiveness of their firms' compliance programs. CCOs should note that the internal controls discussed in this document do not represent an exhaustive list, are not necessarily required by the federal securities laws.

We hope you find this information helpful to your compliance program.

Compliance Rule

Investment advisers are required to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act under Rule 206(4)-7, the "Compliance Rule." Firms should analyze their individual operations and identify conflicts and other compliance factors that create risks for the firm and then design policies and procedures that address those risks. Firms must review their policies and procedures at least annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance offer to be responsible for administering their policies and procedures.

- **Top Deficiencies**
  - Firms did not have adequate or appropriate compliance policies and procedures.
  - Annual reviews of firms' compliance programs were not conducted and/or documented.
  - Compliance policies and procedures were not followed.

- **Examples**
  - Although an adviser's compliance policies and procedures required the CCO to provide a quarterly written report to management regarding the compliance function, a written report was not prepared.
  - An adviser's compliance program did not address the monitoring and oversight of various third-party service providers, including a sub-adviser utilized to manage client accounts.
  - An adviser conducted its annual review and uncovered several areas where its policies and procedures had been violated in addition to areas where policies and procedures required amendment. However, the adviser did not remediate these issues.
  - An adviser did not conduct an annual review during 2006.
  - The CCO was required by the adviser's policies and procedures to prepare a written report outlining the results of the annual review, but this report was not prepared.
  - A pension consultant investment adviser did not have policies and procedures specific to its pension consulting business.

- **Effective Controls to Consider**

  - Use the annual review process to identify potential compliance risks, evaluate current policies and procedures, and develop and implement new policies and procedures to effectively manage and mitigate those newly identified risks.

  - Conduct an ongoing review of the compliance program throughout the year and implement controls to mitigate compliance risks as they occur.

  - Develop and implement new policies and procedures as business practices change (i.e., new products, new processes, new personnel, etc.).

- **Resources**

  - Rule 206(4)-7 under the Advisers Act.

  - *Compliance Programs of Investment Companies and Investment Advisers,* Advisers Act Release No. 2204 (Dec. 17, 2003), available on the SEC's website at http://www.sec.gov/rules/final/ia-2204.htm.

Information Processing and Protection

The Commission adopted Regulation S-P, which concerns the privacy of consumer financial information, in accordance with Section 504 of the Gramm-Leach-Bliley Act. Under Regulation S-P, advisers are limited in their ability to share personal nonpublic information with nonaffiliated third parties. Advisers must adopt and maintain adequate policies and procedures for the safekeeping of nonpublic personal information and must provide a privacy notice to clients initially and annually. The Commission has stated that an adviser's policies and procedures should include business continuity plans. An adviser's fiduciary obligation to its clients includes the obligation to take steps to protect the clients' interest from being placed at risk as a result of the adviser's inability to provide advisory services after, for example, a natural disaster or, in the case of some smaller firms, the death of the owner or key personnel.

- **Top Deficiencies**
  - Firms' privacy notices did not meet the requirements of Regulation S-P.
  - Business continuity plans were not established and/or tested.
- **Examples**
  - An adviser had not contemplated or established a privacy policy.
  - The privacy notice provided by an adviser did not include the manner in which the adviser collected consumer financial information.
  - Although the adviser had a privacy policy and initially supplied this policy to its customers, a privacy notice was not provided on an annual basis.
  - An adviser's business continuity plan did not include provisions for the loss of access to its facilities.
  - A small adviser did not have procedures or contingencies in the event of the death or incapacitation of the owner.
- **Effective Controls to Consider**
  - Document the initial delivery of the privacy notice in the investment advisory agreement.
  - Deliver the annual privacy notice in conjunction with another document and maintain an internal record of this delivery (e.g., deliver with the annual offering

of the disclosure brochure, deliver with the client's quarterly account statement, etc.).

- Review the business continuity plan to ensure that it covers risks to all important resources, including facilities, utilities, personnel, communications, and market access. In good practice, the business continuity plan's primary focus should be clients' prompt access to funds, securities, and account information in the event of an emergency.

- Test the business continuity plan on a regular basis and follow-up on areas of weakness.

➢ **Resources**

- Regulation S-P under Securities Exchange Act of 1934.

- *Privacy of Consumer Financial Information (Regulation S-P),* Advisers Act Release No. 1883 (June 22, 2000), which is available on the SEC's website at http://www.sec.gov/rules/final/34-42974.htm.

- *Compliance Programs of Investment Companies and Investment Advisers,* Advisers Act Release No. 2204 (Dec. 17, 2003), available on the SEC's website at http://www.sec.gov/rules/final/ia-2204.htm.

Performance Advertising and Marketing

To protect investors, certain types of advertising practices by advisers are prohibited. An "advertisement" includes any written communication addressed to more than one person that offers any investment advisory service with regard to securities under Rule 206(4)-1, the "Advertising Rule." Advertising must not be false or misleading and must not contain any untrue statement of a material fact. If advisers advertise investment performance, they should disclose all material facts necessary to avoid misleading existing or prospective clients and should ensure that all supporting documentation is maintained.

- **Top Deficiencies**

  - Advertisements did not include the disclosures necessary to prevent the advertising from being misleading.

  - Disclosures included in advertisements were inaccurate.

  - Firms' inaccurately claimed compliance with GIPS.

  - Composites were inappropriately constructed.

- **Examples**

  - The marketing brochure used by an adviser overstated the adviser's abilities and did not disclose the possibility of loss and the fact that past performance is no guarantee of future results.

  - An adviser included a claim in a marketing brochure that it was unable to substantiate.

  - An advertisement used by an adviser included performance results that were presented gross of fees but was not accompanied by performance net of fees.

  - An advertisement containing performance figures did not disclose whether those performance results reflected the reinvestment of dividend when reinvested dividends materially affected the performance results.

  - An adviser advertised its performance using the results of a model portfolio, but did not disclose that such results do not represent actual trading and that they may not reflect the impact that material economic and market factors might have had on the adviser's decision-making if the adviser were actually managing clients' money.

- An adviser did not disclose that accounts less than a certain size are excluded from its performance composite, which had a material effect on stated performance.

- Although an adviser invested solely in small-cap stocks, all performance was presented in comparison to the Dow Jones Industrial Average. No disclosures regarding the limitations of such a comparison were included.

- **Effective Controls to Consider**

  - Periodically test recordkeeping practices to ensure that all documents necessary to substantiate advertised performance are being appropriately created and retained.

  - If claiming compliance with GIPS, review the standards to ensure the claim is accurate.

  - Review responses to requests for proposals and consultant questionnaires to ensure the information reported is accurate and not misleading.

  - Periodically review performance composites. Review client account holdings for an account's appropriateness to a composite, including sector and security concentrations. Compare client account asset levels to composite asset minimums. Review accounts that are excluded from composites to ensure that reasons for the exclusion are adequate and documented. Periodically review composite disclosures to ensure the information reported is accurate.

- **Resources**

  - Section 206 and Rule 206(4)-1 under the Advisers Act.

  - SEC staff no-action letter, *Clover Capital Management, Inc.* (pub. avail. Oct. 28, 1986), available on the SEC's website at http://www.sec.gov/divisions/investment/noaction/clovercapital102886.htm.

  - SEC staff no-action letter, *Investment Company Institute*, (pub. avail. Sept. 23, 1988), available on the SEC's website at http://www.sec.gov/divisions/investment/noaction/ici092388.htm.

  - SEC staff no-action letter, *Mandell Financial Group.* (pub. avail. May 21, 1997), available on the SEC's website at http://www.sec.gov/divisions/investment/noaction/mandell052197.htm.

Personal Trading

Investment advisers are required to adopt a code of ethics under Rule 204A-1, the "Code of Ethics Rule." A firm's code of ethics should set forth the standards of business conduct expected of its "supervised persons" (i.e., its employees, officers, directors and other people it is required to supervise), and it must address personal securities trading by these people. A firm's code of ethics should reflect its fiduciary obligations to its advisory clients and the fiduciary obligations of its supervised persons, and require compliance with the federal securities laws. In order to prevent unlawful trading and promote ethical conduct by advisory employees, firms' codes of ethics must include certain provisions (outlined in Rule 204A-1) relating to personal securities trading by advisory personnel.

- **Top Deficiencies**

  - Codes of Ethics did not meet the requirements of Rule 204A-1.

  - Codes of Ethics were not enforced throughout firms.

  - Personal trading did not appear to be effectively reviewed.

- **Examples**

  - An adviser's code of ethics did not require access persons to promptly report any violations of the code.

  - An adviser's code of ethics required all employees to complete pre-clearance forms prior to affecting any trades for personal accounts. The adviser did not enforce this policy and several employees did not complete this form.

  - An access person of an adviser did not submit quarterly transaction reports.

  - The quarterly transaction reports submitted by an access person did not include transactions effected by the access person's spouse.

  - An access person purchased securities recommended to clients, even though the adviser's code of ethics prohibited such transactions.

  - An adviser's Form ADV contained detailed procedures regarding employees' personal trading. These procedures, however, were not actually in place or enforced at the adviser.

Effective Internal Controls to Consider

- Establish procedures to include access persons’ trades in the electronic trading system, allowing for electronic tracking and review of access persons’ trades.

- Compare personal trading to any restricted lists.

- Periodically analyze access persons’ trading for patterns that may indicate abuse, such as regularly trading ahead of client accounts.

- Compare performance of access person accounts to client accounts with similar investment strategies for performance disparities.

Resources

- Section 204A and Rule 204A-1 of the Advisers Act.

- *Investment Adviser Codes of Ethics*, Advisers Act Release No. 2256 (July 2, 2004), available on the SEC’s website at http://www.sec.gov/rules/final/ia-2256.htm.

- SEC staff no-action letter, *Kleinwort Benson Investment Management Limited* (pub. avail. Dec. 15, 1993), available on the SEC’s website at http://www.sec.gov/divisions/investment/noaction/kleinwort121593.htm.

- SEC staff no-action letter, *Corinne E. Wood (Herbert-Simon Co.)* (pub. avail. April 17, 1986), available on the SEC’s website at http://www.sec.gov/divisions/investment/noaction/herbert-simon031886.htm.

Brokerage Arrangements and Execution

As fiduciaries, investment advisers are required to act in the best interests of their advisory clients, and to seek to obtain the best price and execution for their securities transactions. The term “best execution” means seeking the best price for a security in the marketplace as well as ensuring that, in executing client transactions, clients do not incur unnecessary brokerage costs and charges. To seek to obtain best execution, advisers must periodically evaluate the execution performance of the broker-dealers they use to execute clients’ transactions. Whenever trading may create a conflict of interest for the adviser (for example, participation in soft dollar arrangements), the adviser has an obligation, before engaging in the activity, to obtain the informed consent from its clients after providing full and fair disclosure of all material facts.

- **Top Deficiencies**
  - Internal controls related to brokerage arrangements and execution were inadequate.
  - Conflicts of interest related to brokerage arrangements were not disclosed.
  - Soft dollar practices were inconsistent with disclosure.
- **Examples**
  - A large money manager used one discount broker exclusively to effect all client transactions and did not periodically compare and evaluate this broker’s services to others.
  - An adviser required all traders to select brokers based on execution quality, but a trader was found to effect transactions solely through a broker that employed a close relative without regard to execution quality.
  - An adviser did not disclose that it used client commissions to obtain products or services that were outside the safe harbor under Section 28(e) of the Exchange Act.
  - An adviser did not document its review of its brokerage arrangements and execution.
  - All client transactions were directed to an adviser’s affiliated broker, but this was not disclosed to clients.

- **Effective Controls to Consider**

  - Develop, implement, and systematically review comprehensive policies and procedures that cover practices such as establishing brokerage arrangements and order placement.

  - Establish clear guidelines for broker selection and develop an approved broker list.

  - Periodically review actual trading practices in comparison to what is communicated to clients and prospective clients and document such reviews.

  - Conduct testing of brokerage arrangements and execution. For example, compute the average commission rates paid to broker-dealers used during a period to identify brokers with which the adviser may have undisclosed conflicts of interest.

- **Resources**

  - Section 206 of the Advisers Act.

  - *Interpretive Release Concerning Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Exchange Act Release No. 23170 (Apr. 23, 1986), available on the SEC's website at http://www.sec.gov/rules/interp/34-23170.pdf.

  - *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Exchange Act Release No. 54165 (July 18, 2006), available on the SEC's website at http://www.sec.gov/rules/interp/2006/34-54165.pdf.

  - *Interpretation of Section 206(3) of the Investment Advisers Act of 1940*, Advisers Act Release No. 1732 (July 17, 1998), available on the SEC's website at http://www.sec.gov/rules/interp/ia-1732.htm.

Information Disclosures, Reporting and Filings

Investment advisers are required to prepare certain reports and disclosures and to file certain reports with the SEC. Investment advisers are required to file an annual update of Part 1A of their registration form (Form ADV) within 90 days after the end of their fiscal year. Form ADV filing requirements are contained in Rule 204-1 of the Advisers Act. Firms must *promptly* file an amendment to their Form ADV whenever certain information (outlined in the instructions to Form ADV) becomes inaccurate.

Investment advisers are required to provide their advisory clients and prospective clients with a written disclosure document as set forth in Rule 204-3 under the Advisers Act and to annually offer to deliver such document. Firms may comply with this requirement either by providing advisory clients and prospective clients with Part II of their Form ADV *or* with another document that contains, at a minimum, the information that is required to be disclosed in Form ADV, Part II.

Rule 204-3(b) requires an adviser to deliver its disclosure statement to a prospective client at least 48 hours prior to entering into an investment advisory contract with such a client. Alternatively, an adviser may deliver the disclosure statement to the client at the time of entering into such contract if the client has the right to terminate the contract, without penalty, within five business days after entering into the contract.

- **Top Deficiencies**
  - Form ADV was inaccurate or incomplete.
  - Firms did not make annual offers of Form ADV, Part II to its clients.

- **Examples**
  - Form ADV, Part II included disclosure regarding employees serving as registerd representatives of a broker-dealer, although Form ADV, Part 1 indicated that no employees served as such.
  - An adviser serves as general partner to a private fund client but does not reflect in Form ADV that it has custody of that client’s assets as a result.
  - Form ADV, Part II was not offered to clients on an annual basis.
  - An adviser included its annual offer of Form ADV on its 4^{th} quarter client performance report, but did not document which clients requested Form ADV pursuant to this offer.

- **Effective Controls to Consider**

  - Develop, implement, and systematically review policies and procedures related to the preparation and filing of required forms and reports.

  - Review Form ADV disclosures as part of the annual review process to ensure that such disclosures are consistent with actual business practices.

  - Offer the disclosure brochure in conjunction with the delivery of another document and maintain an internal record of this offer (e.g., with the annual privacy notice, with the client's quarterly account statement, etc.).

  - Inform clients of material changes at the same time the firm updates its Form ADV, Part II.

- **Resources**

  - Rule 204-3 under the Advisers Act.

  - Form ADV (Part 1A and Part II), instructions to the Form, and filing requirements contained Rule 204-1 under the Advisers Act.

  - A list of the amendments that advisers must make to their Form ADV is in the *General Instructions to Form ADV* (Item 4) at http://www.sec.gov/pdf/fadvpo.pdf.

  - SEC staff's responses to frequently asked questions regarding completing and filing Form ADV are available on the SEC's website at http://www.sec.gov/divisions/investment/iard/iardfaq.shtml.

  - *Use Of Electronic Media By Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples Under The Securities Act Of 1933, Securities Exchange Act Of 1934, And Investment Company Act*, Advisers Act Release No. 1562 (May 9, 1996), available on the SEC's website at http://www.sec.gov/rules/interp/33-7288.txt.

Portfolio Management

The Commission has stated that an adviser's policies and procedures should address its portfolio management processes, including consistency of portfolios with clients' investment objectives as well as investment suitability. An adviser's policies and procedures should also provide for adequate oversight of the activities and compliance programs of both affiliated and third-party service providers. Advisers must make and keep records that pertain to providing investment advice and transactions in client accounts with respect to such advice, including orders to trade in client accounts ("order memoranda").

- **Top Deficiencies**

  - Controls to ensure that assets were invested according to client investment objectives and restrictions were inadequate.

  - Firms did not adequately oversee third-party service providers.

  - Complete order memoranda were not maintained.

- **Examples**

  - An adviser failed to comply with clients' stated investment limitations.

  - An elderly client with an income objective was invested largely in volatile stocks.

  - An adviser utilized a sub-adviser to manage client accounts but did not have policies and procedures to review the activities of the sub-adviser and to ensure the appropriateness of the recommendations and investment decisions made by the sub-adviser.

  - The order memoranda used by an adviser included the date and nature of each transaction, but did not indicate who recommended or placed the transaction.

- **Effective Controls to Consider**

  - Maintain and periodically review documentation of client objectives and restrictions.

  - Review client trades and holdings on a regular basis to ensure that transactions are in accordance with client objectives.

  - Periodically contact clients to ensure that objectives and restrictions are current.

- Develop, implement, and systematically review comprehensive policies and procedures related to the oversight of third-party service providers.

Resources

- Rule 204-2 under the Advisers Act.
- *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release No. 2204 (Dec. 17, 2003), available on the SEC's website at http://www.sec.gov/rules/final/ia-2204.htm.

***