

**2006 CCO Outreach REGIONAL SEMINARS  
INVESTMENT ADVISER CASE STUDY  
DISCUSSION GUIDE**

**BASIC SCENARIO**

SEC Registered Advisers, Inc. (“SRA”) has \$47 million under management. It also:

1. Employs four staff; all of whom work from the same location
  - The sole owner of SRA manages all portfolios
  - One employee places all orders
  - One employee serves as director of marketing and CCO
  - One employee provides clerical assistance
  
2. Invests all client portfolios exclusively in no-load, unaffiliated mutual funds through the fund platform of a large, nationally-known broker-dealer

<b>Potential Risks</b>	<b>Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks</b>	<b>Examples of Review Procedures and Forensic Tests Performed</b>	<b>Required Disclosures/Good Practice Disclosures</b>
As a result of its ownership and operational structure, SRA does not have the ability to establish adequate <b>separation of functions</b> .	SRA’s owner’s close involvement in firm operations is an adequate substitute for an extensive separation of functions.	Because certain functions are performed and reconciled by the same individual, SRA implements review procedures whereby another individual test checks such functions. This provides comfort that functions are performed accurately.	Form ADV includes disclosure regarding Registrant’s officers. Any special circumstances that result from SRA’s organizational structure are also disclosed.

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Basic Scenario

Potential Risks	Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks	Examples of Review Procedures and Forensic Tests Performed	Required Disclosures/Good Practice Disclosures
SRA's <b>owner becomes incapacitated</b> for an extended period of time. Clients are unable to contact SRA.			
SRA does not adhere to clients' stated <b>investment guidelines</b> .			
SRA receives " <b>service fees</b> " in relation to holding certain mutual fund products. The service fee compensation varies between investment choices and, therefore, represents a conflict of interest.			

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Basic Scenario

Potential Risks	Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks	Examples of Review Procedures and Forensic Tests Performed	Required Disclosures/Good Practice Disclosures
<p>SRA employs a <b>trading strategy to capitalize on price inefficiencies</b> by (i) short-term trading of shares in excess of disclosed fund restrictions via an omnibus account, and/or (ii) utilizing multiple accounts and multiple names in an attempt to avoid detection by the fund.</p>			
<p>SRA's clients pay <b>two levels of advisory fees</b> for the management of their assets, one directly to SRA and one indirectly to the managers of the mutual funds held in their portfolios.</p>			

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**VARIATION ONE – MORE COMPLEX INVESTMENT STRATEGY**

Now, assume that the number of employees remain the same, but SRA’s AUM increase to \$200 million and SRA:

1. Manages equity, fixed-income, and balanced portfolios
2. Offers a highly complex arbitrage strategy that uses significant leverage
3. Offers an affiliated hedge fund to advisory clients
4. Offers unaffiliated, private placements to clients
5. Starts a small mutual fund

<b>Potential Risks</b>	<b>Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks</b>	<b>Examples of Review Procedures and Forensic Tests Performed</b>	<b>Required Disclosures/Good Practice Disclosures</b>
<p>SRA does not follow clients’ <b>investment restrictions and guidelines</b>.</p> <p>Changes to restrictions and guidelines are not documented.</p>	<p>Client objectives and restrictions are documented and reviewed periodically.</p> <p>Deviations from stated investment objectives or restrictions are (1) identified and documented by SRA and appropriate action is taken; (2) relayed in a timely manner to the CCO; and (3) disclosed to the affected clients.</p>	<p>Review documentation of client objectives and restrictions; compare client restrictions with client holdings and transactions.</p> <p>Review exception reports or other documentation identifying restriction or guideline deviations and documentation of action taken to correct the violation.</p> <p>Periodic review of client investment positions to determine their continued appropriateness with client life and financial changes.</p>	<p>SRA discloses its procedures with respect to its review of client accounts including the person responsible and the frequency.</p> <p>Disclosures of types of investments are listed on Part II of Form ADV, fund prospectus and offering documents of affiliated hedge fund.</p>

Variation One

Potential Risks	Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks	Examples of Review Procedures and Forensic Tests Performed	Required Disclosures/Good Practice Disclosures
<p>SRA does not maintain supporting documentation to substantiate its review of <b>best price and execution</b>.</p>			
<p><b>Side-by-side management</b> of hedge funds and mutual funds or traditional advisory clients' accounts results in a systematic bias in favor of the hedge fund(s).</p>			
<p>SRA places brokerage transactions with broker-dealers or registered representatives that <b>refer investors</b> to its hedge fund, which results in SRA's clients paying higher commission rates.</p>			

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Variation One

Potential Risks	Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks	Examples of Review Procedures and Forensic Tests Performed	Required Disclosures/Good Practice Disclosures
<p>SRA internally <b>values private placement securities</b> held in client portfolios; values given to private placements are not reflective of the true value.</p>			
<p>SRA does not perform adequate due diligence on the compliance policies and procedures of its <b>third-party service providers</b>.</p>			

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**VARIATION TWO – SRA GROWS**

Analyze the fact patterns in **VARIATION ONE** while assuming SRA’s AUM increase to:

1. \$400 million and the number of employees increases to 12
2. \$3 billion and the number of employees increases to 30

<b>Potential Risks</b>	<b>Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks</b>	<b>Examples of Review Procedures and Forensic Tests Performed</b>	<b>Required Disclosures/Good Practice Disclosures</b>
<p>The staff has increased and <b>separation of duties</b> is now possible; however, owner resists such separation.</p>	<p>Due to the number of client/shareholder accounts and amount of assets involved, owner is compelled to delegate responsibilities and establish a chain of command, thereby creating the need to review whether additional policies and procedures related to segregation of duties, lines of communication and additional reporting requirements are necessary.</p> <p>Employees are assigned responsibility for cross checking the work of others to attempt to limit the number and magnitude of “human errors” and to prevent wrong doing.</p> <p>Reporting structure is revised to focus oversight on the high risk areas such as trading, disbursements, etc</p>	<p>Determine the frequency with which employees’ decisions are overridden or modified by the owner. Follow-up on any situations in which the owner has overridden a decision.</p> <p>Review policies and procedures to determine whether they are applicable to the current staffing levels and have been updated to address new personnel and responsibilities.</p>	
<p><b>Access persons</b> are not identified. Employee transactions and outside business activities are not monitored.</p>			

Variation Two

Potential Risks	Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks	Examples of Review Procedures and Forensic Tests Performed	Required Disclosures/Good Practice Disclosures
<p>Increase in the number of client accounts may result in less supervision over deviations from stated <b>investment restrictions and objectives</b>.</p>			
<p>Despite the increase in assets, which may increase SRA's leverage in seeking better execution capabilities and/or allow for more choice of brokers, SRA continues to <b>direct all brokerage to one or a few broker-dealers</b> without reviewing for best execution.</p>			
<p><b>Disaster recovery plan</b> is not reviewed and adjusted to address increased staff. Alternative worksite is no longer adequate to accommodate increased staff.</p>			

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Variation Two

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### VARIATION THREE – AFFILIATIONS

Assume SRA is:

1. Dually registered as an investment adviser/broker-dealer; has advisory reps in 80 different offices around the country
2. Acquired by a large financial services firm that owns other advisers and broker-dealers.

Potential Risks	Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks	Examples of Review Procedures and Forensic Tests Performed	Required Disclosures/Good Practice Disclosures
<p><b>Inadequate supervision</b> and oversight of advisory rep activities across 80 different offices throughout the country.</p>	<p>SRA performs regularly scheduled and surprise branch office visits, and a compliance review is incorporated into these visits.</p> <p>SRA has assigned the necessary personnel and established policies and procedures to monitor the advisory reps in all 80 of its offices.</p> <p>Provide regular training to advisory representatives on various operational and compliance issues.</p> <p>Consider hiring additional staff (or consultants) to perform certain supervisory functions or perform review/analysis.</p>	<p>SRA compliance staff reviews client and rep files to determine whether proper books and records are created and maintained.</p> <p>Test the extent to which advisory reps are monitored.</p> <p>Completes compliance audits to assess effectiveness of supervisory procedures.</p>	<p>SRA discloses in Part II of Form ADV the advisory representative relationship and the supervisory issues that may arise.</p> <p>SRA discloses arrangement in client agreement.</p>
<p>SRA has a <b>financial incentive to churn</b> client accounts.</p>			

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Variation Three

Potential Risks	Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks	Examples of Review Procedures and Forensic Tests Performed	Required Disclosures/Good Practice Disclosures
Affiliations lead to <b>undisclosed conflicts of interest</b> .			
The acquiring firm's <b>compliance program</b> does not adequately address the issues unique to SRA.			

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**VARIATION FOUR – BROKERAGE AND TRADING**

Assume the various size scenarios in **VARIATION TWO** and that SRA’s trading and brokerage practices include the following:

1. Discretion over client brokerage
2. Use of an affiliated introducing and/or clearing broker-dealer
3. SRA’s employees acting as registered reps of an affiliated broker-dealer
4. Soft dollar arrangements
5. Directed brokerage
6. Use of brokers that refer clients to SRA
7. Allowing brokers to cover SRA’s trade errors
8. Acting as adviser to various wrap fee programs
9. Principal and/or cross transactions

Potential Risks	Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks	Examples of Review Procedures and Forensic Tests Performed	Required Disclosures/Good Practice Disclosures
<p>SRA does not seek <b>best execution</b> for managed accounts.</p>	<p>SRA separates the duties of portfolio managers and traders where practical.</p> <p>SRA maintains a list of approved brokers and develops brokerage allocation targets. SRA maintains a list of brokers who sell shares of SRA’s fund.</p> <p>SRA periodically reviews commission rates for all brokers and negotiates rates with its affiliated broker that are at least as good as those obtained from outside brokers (relative to all services provided). SRA maintains a list of negotiated commission rates.</p>	<p>Quarterly review of actual trading allocations.</p> <p>An outside consultant periodically tests the quality of SRA’s executions.</p> <p>Compare brokerage allocation reports to target brokerage allocation list. Compare these lists to the list of brokers who sell shares of SRA’s fund.</p>	<p>Form ADV and prospectus disclose summary of trading policies and procedures and factors SRA considers when selecting brokers.</p> <p>SRA discloses that client trades may be directed to brokers who distribute the related fund.</p> <p>SRA discloses that clients trades may be executed by the affiliated broker-dealer.</p>

Variation Four

Potential Risks	Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks	Examples of Review Procedures and Forensic Tests Performed	Required Disclosures/Good Practice Disclosures
SRA directs trades to an affiliated broker-dealer in order to earn <b>transaction revenue</b> through high commission rates and potential churning.			
SRA purchases products/services <b>outside of the Section 28(e) safe harbor</b> (i.e., non-research) with soft dollars.			
The investment company directs trades to brokers as incentive or <b>compensation for selling shares</b> of the mutual fund to brokerage clients.			

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Variation Four

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Principal trades are executed with the affiliated broker to <b>cherry-pick</b> desirable or dump undesirable securities from/to client accounts.			

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## VARIATION FIVE – MARKETING

Assume SRA markets its services:

1. By advertising performance
2. Through a website
3. On websites sponsored by others
4. Through consultants
5. By using solicitors
6. By responding to RFPs

Potential Risks	Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks	Examples of Review Procedures and Forensic Tests Performed	Required Disclosures/Good Practice Disclosures
<p>Performance advertisements do not include required <b>disclosures</b>.</p> <p>The use of <b>hypothetical returns</b> is not adequately disclosed.</p>	<p>Policies and procedures list all required disclosures. These policies and procedures require that the methodology used to create and maintain return calculations be consistently applied. Changes to methodologies are disclosed.</p> <p>SRA has detailed policies and procedures that address the manner in which composites should be constructed.</p> <p>Performance is verified by an independent third party.</p> <p>Registered reps pre-clear all advertising materials that are independently prepared.</p>	<p>Review materials to determine the presence of all required disclosures.</p> <p>Determine whether legal opinions/interpretations were obtained, if necessary.</p> <p>Review operating guidelines of portfolio management system to determine whether the system accurately computes performance.</p> <p>Obtain and review reports prepared by third party performance verifiers.</p>	<p>All required disclosures are included in advertised performance.</p> <p>The use of hypothetical returns is prominently disclosed.</p>



Variation Five

<p>SRA does not maintain all data necessary to <b>support investment performance</b>.</p>			
<p>Performance numbers are <b>incorrectly calculated</b>.</p>			
<p><b>Performance composites</b> are constructed in a way that skews investment performance.</p>			

Variation Five

SRA uses third-party solicitors without complying with <b>Rule 206(4)-3.</b>			

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## VARIATION SIX – ADDITIONAL COMPLEXITIES

Assume SRA:

1. Charges performance fees
2. Meets regularly with issuers and serves on creditors’ committees
3. Allows certain employees to serve on boards of directors
4. Publishes a newsletter
5. Chooses securities lending agents for clients
6. Acts as trustee for client accounts
7. Serves as business manager for advisory clients
8. Recommends a private company in which SRA’s principals have a significant ownership interest

Potential Risks	Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks	Examples of Review Procedures and Forensic Tests Performed	Required Disclosures/Good Practice Disclosures
<p>SRA charges performance fees that violate <b>Section 205</b> of the Advisers Act or Rules 205-1, 205-2, or 205-3.</p>	<p>SRA’s policies and procedures reflect the requirements of the Advisers Act and rules thereunder and include checklists to determine whether clients qualify for performance fees.</p> <p>A designated person reviews the calculation method for compliance with the rules.</p> <p>SRA’s compliance policies and procedures include detailed instructions for calculating performance fees.</p>	<p>Periodic review of the qualification status of all clients charged performance fees to verify they meet the qualification requirements.</p> <p>Periodic recalculation of performance fees to determine whether they were calculated properly.</p>	<p>SRA discloses the performance fee calculation method in detail.</p> <p>SRA discloses that it charges performance fees and the conflict of interest created when making investment recommendations and when allocating investment opportunities.</p>

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Variation Six

Potential Risks	Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks	Examples of Review Procedures and Forensic Tests Performed	Required Disclosures/Good Practice Disclosures
SRA favors clients who pay <b>performance fees</b> when allocating investment opportunities.			
SRA's newsletter includes <b>recommendations of securities held by employees</b> to drive up the price of these securities.			
Newsletter includes <b>inaccurate performance numbers</b> .			

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<p>SRA receives <b>additional compensation</b> (i.e., a “kickback”) or other economic benefits for selecting a particular securities lending agent over another.</p>			
<p>As trustee to clients’ accounts, SRA has the ability to <b>misappropriate clients’ funds</b>.</p>			
<p>Clients are unaware of the <b>conflict of interest</b> created by the principals’ ownership interest in the private company.</p>			

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