FPA'S ANNUAL CONFERENCE AND EXPOSITION
SAN DIEGO, CALIFORNIA

SEPTEMBER 18, 2005

<u>SWIMMING IN COMPLIANCE?</u>

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Ms. Stafford thanks Timothy C. Klink of Stafford + Associates llc for his assistance in preparing this paper.

SWIMMING IN COMPLIANCE?

INTRODUCTION

In the last two years, the Securities and Exchange Commission promulgated a multitude of new rules and addressed well-known problems in the financial planning and investment advisory industry.[1] The Commission addresses its views through rulemaking, enforcement actions and deficiency letters.[2] In promulgating rules, the Commission sets forth the rule and accompanying release; however, they may provide minimum guidance on how to proceed. Then, enforcement actions and deficiency letters are fact specific to the matter at hand and of minimal assistance in determining another firm's compliance programs. Enforcement actions and deficiency letters state areas to avoid but not necessarily guidelines in proceeding. This current increased regulation is still confusing, particularly in the face of having little or no direction from the Commission or the examiners themselves.[3]

Many investment advisory firms are left to "guess" what must be done to comply with new regulations. Speeches and other pronouncements by the Commission indicate the intent in going forward in various areas and provide more guidance. Enforcement actions and deficiency letters outline areas to avoid. With the amount of recurrent regulation, many unaddressed topics yet remain for the Commission to address.

This paper addresses the recent rules effective within the last year or so and operational issues and disclosures, all in the context of compliance. This paper covers issues for a federally-covered advisor but thereby provides the most uniform set of rules, to which many states reference. Even if a state fails to reference these standards, the federal requirements present a good framework of what may be considered fraudulent or deceptive conduct under state law and a method to minimize criticism in state examinations.

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* All individuals referenced are the Commission members and its staff of the United States Securities and Exchange Commission.

[1] Commissioner Cynthia A. Glass, Remarks at the SIA Compliance & Legal Divisions 35 Annual Seminar, Mar. 23, 2004. *See* Paul S. Atkins, Remarks Before SEC Speaks in 2005, March 4, 2005, stating:

> "Jack's [Katz] office approved more than 25 orders and litigation releases in a single day."

[2] Lori A. Richards, Director, Office of Compliance Inspections and Examination, Culture of Compliance, Spring Compliance Conference, National Regulatory Services, Apr. 23, 2004.

[3] *See* Lori Richards, Director, Office of Compliance Inspections and Examinations, Financial Services Institute: First Annual Public Policy Day, Oct. 24, 2004.

RECENT RULES

Rule 206(4)-7, Compliance Programs

The most sweeping rule recently implemented by the Commission is Rule 206(4)-7[4]. It requires the implementation of written policies and procedures and an annual review of those policies and procedures, all to be administered by a newly-appointed Chief Compliance Officer. The rule is quite short, leaving wide interpretation as to what fulfills its requirements. Some guidance exists in the original release but not defined standards. Although of assistance, the scattered speeches bear no actual authority.[5] Industry efforts currently aim to establish common standards tailored to each firm that the Commission may review on a consistent basis across multiple advisors and hopefully accept these standards for the industry.

The release itself is far more informative than the rule and should be referenced as a first source with questions.[6] The release obstensively sets minimum requirements to be addressed in the policies and procedures, including without limitation:

- portfolio management process,
- trading practices,
- proprietary and personal trading activities, since moved to the Code of Ethics,[7]
- disclosure accuracy,
- safeguarding of client assets,
- record retention and maintenance,
- marketing advisory services,
- valuation and fees,
- client privacy, and
- business continuity plans.

These categories are quite broad. Beyond the release, comments from speeches by Commission staff contain information as to the more specific issues in these categories. The staff typically focuses on the desired actions to be pursued by the industry in its review and problems found in examinations of investment advisors.

The release goes into less detail on duties of the Chief Compliance Officer, merely stating that it should be her duty to administer the compliance policies and procedures.

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[4] Rule 206(4)-7, *Compliance Programs of Investment Companies and Investment Advisors*, promulgated under the Investment Advisor Act of 1940, http://www.law.uc.edu/ccl/xyz/sldtoc.html; *Compliance Programs of Investment Companies and Investment Advisors*, Release No. IA-2204, Dec. 17, 2003.

[5] *E.g.*, Richards, *supra* notes 2 and 3:

> "As a matter of policy, the SEC disclaims responsibility for any private statement by an employee. The speaker's views are her own, and do not necessarily reflect those of the Commission, the Commissioners, or other members of staff."

[6] Release No. IA-2204, *supra* note 4.

[7] *See* Rule 204A-1, *Code of Ethics*, promulgated under the Investment Advisors Act of 1940, http://www.law.uc.edu/ccl/xyz/sldtoc.html.

Thereafter, the Commission's view of the Chief Compliance Officer's position ranges from a deputy of the Commission[8] to a friend and copatriot in arms.[9] The most noteworthy requirement found in the release involves the power granted to the Chief Compliance Officer. The Chief Compliance Officer should be empowered with the authority to develop and enforce the policies and procedures for the firm, as well as have sufficient seniority and authority to compel the adherence of others to the policies and procedures. Further, the Chief Compliance Officer should have sufficient background knowledge and experience to implement the rule.[10] One recent deficiency letter cited the appointment of an unqualified Chief Compliance Officer.

The staff indicates that advisors should conduct their compliance programs on a risk-based analysis. [11] Firms must identify the risks faced and then craft and implement policies for these risks. This risk-based analysis presents challenges to search for and determine "risks", especially with a well-run shop. Some possible examples of risks: qualitative execution; trading practices; business succession; conflicts of interest; e-mail retention[12] and securing books and records.[13]

The Commission's most frequent complaint with adherence to this rule is advisors' lack of adequate policies and procedures covering the topics in the release. The Commission stresses that the policies and procedures should be ever-evolving and improved over time. One pitfall of many advisors is the failure to update, test, and improve on the procedures.[14]

Another prominent shortcoming found by the Commission is the failure to follow and implement adequate procedures after drafting and adopting the compliance manual. Well written and inclusive policies and procedures become useless if the employees of the firm do not adhere to them. First, the policies and procedures should be presented and understood by the firm's staff. The Chief Compliance Officer must then implement the policies and procedures, testing

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[8] David Hoffman, *CCO outreach program has few fans*, INVESTMENT NEWS, Mar. 21, 2005.

[9] *E.g.*, Lori A. Richards, Director, Officer of Compliance Inspections and Examinations, Remarks before the Investment Adviser Compliance Best Practices Summit: Compliance Programs: Our Shared Mission, Feb. 28, 2005.

[10] *Cf.* Lori Richards, Director, Officer of Compliance Inspections and Examinations, Compliance: Some Core Principles, National Regulatory Services Twentieth Annual Spring Compliance/Risk Management Conference, Apr. 20, 2005.

[11] Mary Ann Gadziala, Rebuilding Ethics and Compliance in the Securities Industry, Remarks before the NYSE Regulation First Annual Securities Conference, Jun. 23, 2005.

[12] Brodie Southall, *Advisors grapple with SEC's e-mail directive*, INVESTMENT NEWS, May 16, 2005.

[13] Lori A. Richards, Director, Office of Compliance Inspections and Examination, The New Compliance Rule: An Opportunity for Change, Investment Company Institute, Independent Directors Council, Mutual Fund Compliance Conference, Jun. 18, 2004.

[14] Richards, *supra* note 2.

for effectiveness.[15] An example is assuring that personal securities transaction reports are being submitted and reviewed. Then, in review of the personal securities reports, the Chief Compliance Officer confirms any required preclearance for a securities transaction.

A system of testing for compliance must be established. The Chief Compliance Officer should confirm that investment objectives for each client are being met by reviewing client files and portfolios.[16] If all or a significant number of client portfolios are similarly managed, it warrants further investigation. Policies on trading practices may be monitored by reviewing trade memoranda that indicate the actual execution prices were within market limits. Internal controls should be set up such that failure to follow compliance procedures is detectable by the Chief Compliance Officer.[17]

Among many methods, a policy should require employees to report violations, and a failure to do so imposes the same violation against the nonreporting employees. Employees should be empowered to question conduct that may be contradictory to the policies and procedures. There should be an identified contact, most likely the Chief Compliance Officer, with whom the employees may have free dialogue regarding any possible violations. Communication of bad news should be encouraged so that violations may be addressed and rectified.[18] Policies and procedures should make the failure to report a violation, a violation of itself.

Recently the staff focused on the annual review required by the Rule. The Rule requires an annual review of the adequacy of the policies and procedures and their effectiveness. A book could be written in response, but what does the Commission expect? Suggested areas: [19]

- material changes to the policies and procedures;
- recommended changes;
- compliance matters arising;
- ability to detect problems; and
- effectiveness in deterring and detecting violations.

The review should find something, whether needed material changes, compliance matters arising or effectiveness of the compliance program. A perfect compliance program is nonexistent. Compliance matters will arise. Further, the compliance program must detect

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[15] Lori A. Richards, Director, Office of Compliance Inspections and Examination, Put the Compliance Rule to Work, IA Best Practices Summit, March 15, 2004; Lori A. Richards, Compliance Issues for Investment Advisors Today, Remarks at Investment Counsel Association, Investment Advisor Week, Investment Advice Compliance Summit, April 28, 2003.

[16] *Cf.* Lori Richards, Director, Office of Compliance Inspections and Examination, A Renewed Commitment to Compliance, Remarks before the National Society of Compliance Professional, 2004 National Membership Meeting, October 28, 2004. *See also* Donald B. Trone, *An investment policy statement, done right, is vital*, INVESTMENT NEWS, Apr. 18, 2005.

[17] Gadziala, *supra* note 11.

[18] Richards, *supra* note 13.

[19] *Cf.* Richards, *supra* note 13.

problems. The Commission expects to find something reported otherwise it is almost as if the annual review was not conducted effectively.

In conducting the annual review, some suggest the review be done in modules or segregated parts pertinent to various subject matters.[20] For example, modules of review may be the items indicated above; then: investment suitability, registration, disclosures, trade execution, trading practices, and Code of Ethics. This manner eases the review for the Chief Compliance Officer and the directors. The modules may be presented over several Board meetings and addressed fully, instead of during one lengthy meeting and its attendant consequences.

Rule 204A-1, Code of Ethics

This Rule[21] requires written procedures be adopted governing the conduct of investment personnel as well as conflicts that arise from personal trading by securities personnel. The Code of Ethics should:

- set standards of business conduct reflecting fiduciary obligations,
- require compliance with federal securities laws,
- require periodic reporting and review of personal securities transactions,
- require reporting of any violations of the Code of Ethics, and
- require written acknowledgement of receipt of the Code of Ethics.

Rule 204A-1's primary focus is personal securities transactions. It requires the following procedures:

- All access persons are required to file various personal securities reports throughout the year.
- Access persons include all officers, directors and partners, as well as any supervised person who has access to non-public client information or who is involved in making any securities recommendations to clients, or has access to such non-public recommendations.
- Reports stating holdings of beneficial interest in reportable securities, including any reportable funds, must be submitted to the Chief Compliance Officer within 10 days of becoming an access person and at least once annually.
- All access persons submit to the Chief Compliance Officer within 30 days after each quarter-end a report identifying each transaction in reportable securities that was effected for that access person's personal account during that quarter.

These reporting requirements are not required for investment advisory firms with only one access person. For these one man firms, records of holdings and transactions requiring reporting must simply be maintained in the advisor's files.[22]

[20] Remarks during the presentation of seminar entitled "Status Check on CCO's and Their Compliance Programs, Regulatory Updates, Marketing Ideas, Industry Hot Topics and all that Jazz", U.S. Bancorp Fund Services, LLC, Annual Client Conference, Jun. 16, 2005.

[21] Rule 204A-1, *supra* note 7.

[22] *Investment Advisor Codes of Ethics*, Release No. IA-2256, Jul. 2, 2004.

Beyond these specific requirements, many items are left to the firm according to its operations, size and manner of investing.[23] Firms are given discretion regarding the preclearance of securities trades. The firm may decide in what situations and through what procedures it will require preclearance in all but two situations. Access persons are required to receive preclearance before they acquire any beneficial interest in initial public offerings and limited offerings. However, many firms simply prohibit the acquisition of initial public offerings because of the great potential for abuse in the form of conflicts of interest. Very likely, the initial public offering should be allocated to the client.

Similarly in limited offerings, because of the great potential for a conflict to arise, firms prohibit these investments. For example, if a portfolio manager invests in a favorable limited offering, his incentive becomes to increase the issuer's value to his benefit and not necessarily the client's interests.[24]

Preclearance of trades may, at the firm's discretion, be required for all securities, except exempt securities, such as mutual funds other than those funds under agreement with the advisor. If the Chief Compliance Officer is unfamiliar with the firm's investment activities, preclearance by an additional person familiar with the investments is advisable, such as a senior portfolio manager. Then, of course, some other person must preclear the Chief Compliance Officer's trades.

The intent of this Rule is beyond the prevention of insider trading and aims at fraudulent conduct. It aims at front-running, conflicts of interest, obtrusive trading practice and any conduct not in the best interest of the firm's clients. Requiring reports of personal securities enables the Chief Compliance Officer to detect illegal or inappropriate conduct and the failure to receive preclearance.

Rule 206(4)-2, Custody of Funds or Securities of Clients by Investment Advisors

The Commission standardized treatment of custody of client assets, recognizing modern custodial practices and defining "custody".[25] Prior to the rule's adoption, the Commission and advisors relied on a series of no-action letters to avoid custody upon automatic deduction of advisory fees, which action was deemed to impute custody.[26] Among other items, the Rule simplifies the procedures for doing so.

The definition of the term "custody" cites examples in which an advisor holds custody of client assets. An advisor who holds directly or indirectly, any client funds or securities, or has

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[23] *Id.*

[24] *Cf., Securities and Exchange Commission v. Commonwealth Chemical Securities*, 574 F.2d 90 (2nd Cir. 1978).

[25] Rule 206(4)-2, *Custody of Funds or Securities of Clients by Investment Advisors*, Investment Advisors Act of 1940, http://law.uc.edu/ccl/xyz/sldtoc.html. *See Custody of Funds or Securities of Clients by Investment Advisors*, Release No. IA-2176, Sep. 25, 2003.

[26] *See John B. Kennedy* (pub. Avail. June 5, 1996); *Blum Shapiro Financial Services, Inc.* (pub. Avail. April 16, 1993); *Seth C. Warner & Co.* (pub. Avail. April 18, 1985); *Crocker Investment Mgmt. Corp.* (pub. Avail. April 14, 1978); and *PIMS, Inc.* (pub. Avail. Oct. 21, 1991).

the authority to obtain possession of them is deemed to have custody, which is deemed fraudulent and deceptive.[27]

In the automatic deduction of advisory fees from client accounts upon the advisor's presentation of invoices to the custodian, the advisor may avoid custody if the client's assets are maintained with a qualified custodian, the advisor notifies the client of the custodian, and the advisor has a reasonable belief that the qualified custodian is providing the clients with periodic account statements. The Rule defines qualified custodian as a bank, registered broker-dealer and similar financial institutions.

Even though the custodian is sending account statements, the advisor may also send account statements. The advisor's account statements present a good communication tool to its clients. Also, the advisor's statements are often easier to read and present more relevant information for its client than a brokerage account statement.

Actual possession of client funds or securities is custody unless the funds or securities are received inadvertently and returned to the sender promptly, but in any case within three days. An advisor should not accept checks made payable to it and return any such check immediately. An advisor may receive checks made payable to the custodian and forward them promptly to the custodian, preferably the same day of receipt. An advisor should never accept cash.[28]

An advisor may assist a client in forwarding a certificate and stock power. However, the client must actually deliver the certificate to the custodian whether in person or by a Federal Express envelope handled by the client. The advisor may show the client how to transfer the certificate into the client's account.[29]

The Commission's staff announced its enforcement stance to look closely[30] at custody, particularly the requirement that statements be sent from the custodian directly to the client. Many examples exist in which advisors sent only their statements, the clients received no independent statements from third-party custodians, and then the clients received no money, the advisor having absconded with the money.[31] The Commission knows that misappropriation of client assets is most likely when an advisor has custody of the client assets, resulting in a heightened review.

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[27] Rule 206(4)-2(3)(B), *supra* note 25.

[28] The U.S. PATRIOT Act and the Bank Secrecy Act do not apply to investment advisors. Therefore, no policies and procedures are required. 31 U.S.C. 5312(a)(2).

[29] Custody of Funds or Securities by Investment Advisors, Release No. IA-2176 (Sep. 25, 2003).

[30] *Cf.* Richards, *supra* note 16; Lori A. Richards, Director, Office of Compliance Inspections and Examination, The Need for More Proactive Risk Assessment, Remarks at NRS Annual Spring Conference, April 14, 2004. Lori A. Richards, Compliance Issues for Investment Advisors Today, Remarks at Investment Counsel Association, IAA Week, Investment Advisor Compliance Summit, April 28, 2003. Lori A. Richards, Letter from the Office of Compliance Inspections and Examinations: To Registered Investment Advisor, on Areas Reviewed and Violations Found During Recent Inspection, May 1, 2000. *E.g.* Brooke Southall, *SEC fires off deficiency letters*, INVESTMENT NEWS, Apr. 25, 2005.

[31] *See e.g.*, <u>In the Matter of Sagam Management Corp. and Sagam Capital Inc</u>., IA-2296 (September 15, 2004); <u>Securities and Exchange Commission v. Berger</u>, 322 F.3d 187 (Feb. 27, 2003); <u>In the Matter of F. Xavier Saavedra</u>, IA-7894 (August 10, 2000).

Rule 206(4)-6, Proxy Voting by Investment Advisors

This Rule[32] deems it fraudulent and deceptive for an investment advisor to exercise voting authority unless the advisor has adopted and implemented policies and procedures designed for proxies to be voted in the best interests of the client. Further, advisors must describe their proxy voting procedures to their clients, make a copy available upon request, and disclose to the clients how they may obtain information on how the advisor voted their proxies.

The proxy rule applies to all advisors that have the express or implied authority to vote clients proxies, whether it is through express language or through the grant of a broad discretionary power. To determine this authority, the advisor must closely review the language in the advisory contract. Of course, to avoid any misunderstanding, the contract or agreement should state directly whether the advisor has authority to vote proxies. If it may be implied from the broad discretionary language and the advisor does not vote proxies, the advisor should inform clients that it is not voting proxies. The advisor should assure proxy materials are forwarded to clients.

Voting proxies requires additional work and documentation. When charging a full advisory fee, the advisor should conduct all action necessary in the best interests of the client including the vote of proxies in a manner to enhance shareholder value. A firm may not simply ignore proxies if it has taken on the authority, implicitly or explicitly, to vote them. Further, voting proxies in the best interests of the client enhances shareholder value for the client.

The better course of action as a fiduciary[33] is to vote proxies on behalf of clients. The advisor researches the issues, knows the issuer and has the best knowledge to vote proxies in a manner designed to increase shareholder value. In comparison, a client relying on the advisor to make informed investment decisions has minimal knowledge to vote proxies from an issuer of which he has no knowledge.

As with many of the other new rules, this rule sets requirements for procedures without any directions on the actual procedures. The actual written proxy policies are left to the firm, providing flexibility among many types and sizes of advisors. The Release[34] recommends the advisor set up procedures by which it may monitor corporate actions to vote in its client's best interests. Procedures must also exist to resolve any conflict of interest with a client.

A review of corporate governance issues over the last decade may outline proxy policies and procedures. For example, policies may provide that proxies are voted against excessive management compensation not in line with shareholder interests. For a mutual fund, an advisor may consider to vote against all 12b-1 plans, especially if a distribution system is in place.

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[32] Rule 206(4)-6, *Proxy Voting by Investment Advisors*, promulgated under Investment Act of 1940, http://www.law.uc.edu/ccl/xyz/sldtoc.html. *See also*, *Proxy Voting by Investment Advisors*, January 31, 2003, Release No. IA-2106.

[33] *S.E.C. v. Capital Gains Research Bureau*, 375 U.S. 180, 191-192 (1963).

[34] Release No. IA-2106, *supra* note 32.

The procedures must designate persons responsible for receiving proxy materials, tracking proxy voting deadlines, distributing the materials to the appropriate persons and recording proxy votes. The designated person most appropriate to vote proxies is the person making investment decisions as most familiar with the issuers.

The proxy voting policies and procedures must be briefly described to all clients, and upon request, a full copy of the policies and procedures made available to them. This availability must also be disclosed, best placed in the Form ADV, Part II.

CONFLICTS OF INTEREST

High on the hot topics list is conflicts of interest.[35] Most abuses and enforcement actions arise because of the failure of the advisor to place the client's interests first. The advisor enters into an arrangement or action creating a conflict with the client, and then fails to disclose it and receive consent if necessary.

Execution of Transactions

The Commission demonstrates its enforcement vigor through the multitude of enforcement actions in this area, imposing billions of dollars in fines.[36] Many actions involve the brokerage and mutual fund industry, but investment advisory firms must be alert. The advisor must seek the best qualitative execution for its clients. Best qualitative execution goes beyond best price, and best execution to cover such intangibles as prior experience, certainty of trades, financial condition, client comfort, error correction, service and similar factors. A primary concern is that advisors may utilize brokers that give the advisor something extra for directed brokerage, outside the scope of any safe harbors, such as currently exist for soft dollars.

The Commission looks at the way advisors seek to attract investment advisors when examining the broker usage of advisors.[37] Hence, most transactions between an advisor and broker to the detriment of the client will be unlawful. Everything else is suspect. With the competitiveness of commission costs, advisors must be fully ready to justify their use of a broker and the commissions.

For example, if an advisor causes clients to pay excessive commissions to a certain broker-dealer in exchange for client referrals to the advisor from the same broker-dealer, it is not in the best interests of the client. Reciprocal client referrals are suspect, in the same manner.[38]

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[35] Gadziala, *supra* note 11.

[36] See, e.g., *NASD Charges 15 Firms with Directed Brokerage Violation, Imposes Fines Totaling More Than $34 Million, Disciplinary and other NASD Actions* (June 2005), http://www.nasd/web/groups/enforcement/documents/monthly_disciplinary_actions/nasdw_104454.pdf.

[37] Gadziala, *supra* note 11.

[38] Lori A. Richards, Director, Office of Compliance Inspections and Examination, Compliance Issues for Investment Advisory Today, Remarks at Investment Counsel Association/IA Week Investment Advisor Compliance Summit, April 28, 2004; Lori A. Richards, Letter from the Office of Compliance Inspections and Examination to Registered Investment Advisors, on Areas Review and Violations Fraud During Inspection, May 1, 2000, www.sec.gov/divisions/ocie/advltr.html.

Gifts and gratuities from broker-dealers are further questionable, especially if exceeding the NASD Rules of Conduct guidelines.[39]

The advisor must disclose its execution policies and the factors it considers in selecting or recommending brokers and dealers. Thereafter, an advisor is charged with continuously and systematically reviewing its brokerage arrangements so that the clients continue to receive best qualitative execution. The information gathered during these periodic reviews should be documented and compared to its disclosures to assure consistency between the disclosures and practice.

Trading Policies

An advisor has the duty to ensure that the client is getting the best qualitative execution on trades placed for that client's account.[40] For example, riskier investments should not be placed in a low risk tolerance account, even if intended to pump up performance. Related to best execution are the findings of the Commission staff that advisors commonly fail to review execution quality systematically and periodically, and change execution practices accordingly. Further, advisors must document this review. The review depends on the firm, its size, frequency of trades and type of investment.

Firms must review their trades after execution to confirm proper execution. After or upon placing a trade, the firm must confirm the terms are correct and compare the price to market conditions. Many advisors use the "average volume weighted price" computed as of day-end compared to the execution price actually received. For mutual funds orders, confirmation of terms only applies. All funds price at net asset value the day of order placement.

When examining advisors, the Commission notes the allocation of investment opportunities among clients and the consistency of portfolios with the client's investment objectives.[41] Investment allocation has the potential to harm and defraud clients if the allocations are contrary to the client's expectations.[42] For example, riskier investments should not be placed in a low risk tolerance account to pump performance. Advisors should adopt and adhere to strict policies and procedures pertaining to allocation to avoid the ire of the Commission on this particular subject. Some of the more common methods by which advisors defraud their clients are when the advisor disproportionately allocates hot initial public offerings, bond offerings, or other "favored" investments to favored clients. Therefore, advisors must

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[39] NASD Manual, Rules of Conduct, Rule 3060, www.nasd.com, under Rules and Regulation.

[40] *Cf. e.g.*, Lori A. Richards, the Securities and Exchange Commission's Examination of Mutual Funds, Before the Senate Committee on Banking, Housing and Urban Affairs, March 10, 2004; Chairman William H. Donaldson, Remarks before the SEC Speaks Conference, March 24, 2004.

[41] Lori A. Richards, Director, Office of Compliance Inspections and Examination, Compliance Issues for Investment Advisors Today, Remarks at the Investment Council Association/IA Week, Investment Advisor Compliance Summit, April 28, 2003.

[42] *E.g.*, In the Matter of F.W. Thompson Company Ltd. And Frederick W. Thompson, IA Release No. 1895; September 7, 2000; In re McKenzie Walker Investment Management, Inc. and Richard C. McKenzie, IA Release No. 1571, July 16, 1996.

disclose the methods they use to allocate investments among clients' accounts, thereby imposing a standard of fairness.[43]

Soft Dollars

Soft dollar[44] regulation, while on the horizon for a number of months, has recently been stalled by the departure of Chairman Donaldson and the Director of Investment Management. Upon the fulfillment of these two positions, the expectation is that proposed rules should be offered by the Commission in the future.[45] The Commission has already assembled a Soft Dollar Task Force, charged with the task of investigating and studying any possible changes to the current regulatory structure. A number of speeches also have been given by Commission staff indicating that it is aware that soft dollars need to be addressed and will be so in the near future. Further, the Commission staff has indicated that it will consider industry reviews,[46] such as a recent report by the NASD Mutual Fund Task Force.[47]

Two primary rule changes are expected regarding soft dollars. First, the definition of "research services" will be narrowed to an intellectual-based concept, i.e., thoughts, ideas and concepts. The NASD recommended that the definition of "research services" be narrowed such that only those brokerage services in Section 28(e)(3) of the Securities Act of 1934 be allowed.[48] Section 28(e)(3) sets forth allowable soft dollars concerning advice on securities, analysis and reports and any intellectual content of that research. "Intellectual content" is defined as any investment formula, idea, analysis, or strategy that has been developed, authored, provided, or etc. applied by the broker or a third-party research provider.

The NASD named some currently protected products that should no longer be protected. The newly unprotected items would be computer hardware and software unrelated to any research content, phone and data transmission lines, terminals and similar facilities, periodicals, portfolio accounting services, proxy voting services unrelated to issuer research, and travel expenses. Discounts offered on these products create an element of soft dollars.

The NASD also recommended the limiting of mixed-use items to those products and services that are significantly related to research. The safe harbor should only protect those products that have a significant research use within the safe harbor. There should be a readily recognizable and significant research element in any mixed-use item.

The second primary rule change advocated by the NASD concerns disclosure. Although the recommendations are aimed at mutual fund disclosure, the recommendations went further to

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[43] Gadziala, *supra* note 11.

[44] *See* Section 28(e)(3) promulgated under the Securities Act of 1934, http://www.law.uc.edu/ccl/xyz/sldtoc.html.

[45] Commissioner William H. Donaldson, Remarks before the Financial Services Roundtable, April 1, 2005.

[46] Gadziala, *supra* note 11.

[47] NASD Report of the Mutual Fund Task Force, Soft Dollars and Portfolio Transaction Costs (November 11, 2004) http://www.nasd.com/web/groups/rules_regs/nasdw_01356.pdf.

[48] Section 28(c)(3) *supra* note 44.

recommend one set of rules for fund advisors as well as all other discretionary advisors, including nondiscretionary advisors if the client always follows the recommendations.

Previously through its examination process, the Commission forced disclosure of broker selection, execution practices, evaluation of execution and use of soft dollars on Form ADV, Part II. The Task Force's recommendations include specific numerical disclosures, many of which seem inapplicable to general discretionary advisors, not managing mutual funds. Those recommended disclosures include portfolio turnover rates, lists of brokers and commissions paid, in the aggregate and percentage, comparative numbers of brokers providing soft dollars versus those brokers who do not, and an estimate of the value of the soft dollar items received. It remains uncertain how these mutual fund-based rules apply to all advisors.

Given the harshness and complexity being imposed on soft dollars, advisors are limiting or lessening the use of soft dollars. With custodian, broker-dealers, it is yet unclear what services may be deemed soft dollar beyond the clear definitions. Certainly the provision of account statements is not, but account services beyond account statements may be questionable.

Dual-Capacity Disclosure and Consent

When an investment advisor manages client accounts, and an agent of the advisor executes the recommended transactions through a broker-dealer, with whom the agent is a registered representative, a conflict of interest exists.[49] This individual acts in the dual-capacity of an investment advisory representative and a registered representative with respect to the client. This arrangement clearly causes a conflict of interest in that the advisor may be inclined to recommend more transactions to receive commissions, not necessarily in the best interests of the client. Clear rules exist regarding principal transactions[50] but are inapplicable in this instance. It is less clear when an advisor executes transactions other than principal transactions.

The Commission uses Sections 206(1) and (2),[51] with the interpretation that it is unlawful for an investment advisor to defraud their clients in any way, to address this dual-capacity. The Commission interprets an investment advisory agent acting as registered representatives and executing recommended transactions, as a fraud upon the clients unless the investment advisor clearly discloses the conflict and receives prior consent.

Investment advisor agents retain their licenses because of the desire to receive trailers, 12b-1 fees and other commissioned business inappropriate for an investment advisor. The broker-dealer with whom the agent is registered then requires the advisory transactions be executed through it. In essence, industry practices often force this issue.

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[49] *Applicability of the Investor Advisors Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services,* Release No. IA-1092 (October 16, 1987); In re Douglas Jouey, (July 22, 1976); In re Capital Associates, (February 14, 1977); In re Francis L. Netti, (November 29, 1976); In re Kidder, Peabody & Co., Incorporated, et al., File No. 3-1739 (October 26, 2968).

[50] Section 206(3) *Prohibited Transactions by Investment Advisors* of the Investment Advisors Act of 1940, http://www.law.uc.edu/ccl/xyz/sldtoc.html.

[51] Section 206(1) and (2), *supra* note 50.

A number of avenues exist for investment advisors effectively to negate this conflict of interest. The first is the advisor simply waiving all commissions on trades that are executed with dual-capacity, leaving the custodian, broker-dealer with the commissions.

Beyond waiver, disclosure is the only effective way to avoid a fraudulent transaction. First, the dual-capacity must be disclosed in the Form ADV. Then, some type of client consent specific to the transactions executed must be obtained, in writing and in advance.

The nature of the disclosure may be modeled according to actual remuneration received. For those registered representatives that always execute transactions through the same broker or dealer and always charge the same commission price, it may be sufficient to obtain one prior written consent acknowledging that the registered representative will always receive the same amount on each trade, such as $0.03 per cent. Although a logical solution, this method has neither been reviewed by the Commission nor tested in any examination.

Otherwise, if the compensation values or brokerage execution varies, disclosure and consent become much more cumbersome. Prior to each trade in a client's account, the client must consent in writing to each individual trade. Obviously, this result is time-consuming, making the other options more attractive to advisors. By making the disclosure and consent requirements burdensome, the Commission thus accomplishes its ultimate goal of deterring this type of conflict of interest behavior.[52]

OPERATIONAL ISSUES

Business Succession and Continuity Plans

The Commission requires every investment advisor to maintain a business succession and continuity plan, describing the actions of the advisor in the event of loss of person or property.[53] The Commission initially started requiring business continuity plans in the event of a disaster to property, computers, offices or client files, in response to the World Trade Center disaster.[54] The Commission then expanded the plans to include succession planning, providing for the transfer of the business from one generation to the next. These plans address a multitude of issues, including loss of personnel, client data storage and backup, succession contact personnel in the event of a disaster, continuation of the business after the disaster, backup facilities, and succession planning for the continuation and transfer of the business from persons nearing retirement to the next younger group.

Maintenance of client information and records is the foremost concern of any investment advisor. Client electronic information should be preserved such that the destruction of one facility will never cause the complete destruction of the information. The most common procedure is retention of the information on a backup system, separate and distinct from the main

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[52] Chairman William H. Donaldson Remarks before the SEC Speaks Conference, March 24, 2004.

[53] Richards, *supra* note 13.

[54] Lori A. Richards, Director, Office of Compliance Inspections and Examination, Compliance Professional Play Proactive Defense, National Society of Compliance Professional, October 18, 2001.

system and stored separately. Any plan must safeguard client information by means that make it highly unlikely that the backup information could be compromised.

The plan provides for the continuation of the business activities and service to clients. Upon the event of disaster, employees must have a series of persons to contact regarding the business. These names and numbers should be included in the plan. Also included in the plan should be policies regarding the actual facilities from which the business continues in the event that the original facilities are no longer available for use. That facility may range from a personal residence to a backup commercial facility. Clients and their information may then be accessed through the back-up data.

A business succession plan must accompany a business continuity plan for the transition of the business. This issue applies most poignantly to one man shops or firms dominated by one person, typically the founder. For a one man shop, the succession plan may be as simple as notification to clients upon the unavailability of the advisor, the clients knowing where their assets are held and that they may contact the custodian for assistance. However, a more complicated plan may be required with frequent or risky trading, such as an arrangement for another advisor to take preventative action until the accounts are stabilized and further action may be taken.

For founder-dominated firms, most firms either have a potential successor or successors in place and being trained. Depending on the nature of the arrangement, a shareholders agreement may also be in place. The intent is to transfer the business operations serving the clients seamlessly. During the transfer, the new group becomes familiar and gets to know the client to be able to serve the client's investment needs.

When transferring business and clients, a firm must be aware that Section 205(a)(2)[55] prohibits the assignment of investment advisory contracts without client consent. Beyond an actual assignment, Section 202(a)(1)[56] defines a de facto assignment as change in ownership and Rule 202(a)(1)-1[57] indirectly states a change of management is an assignment.

Privacy and Secured Client Information

Client privacy in the investment advisory setting depends upon adherence to Regulation S-P[58] and the interpretative permutations thereafter. This Regulation requires, among other things, the strict safeguarding of the privacy of client information. The clients have to be notified of the firm's privacy policies. The regulation also requires that the firm verify that client information is compiled accurately and it is protected from unauthorized changes.

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[55] Section 205, *Investment Advisory Contracts*, Investment Advisors Act of 1940, http://www.law.uc.edu/ccl/xyz/sldtoc.html.

[56] Section 202(a)(1), *Definitions, Assignment,* Investment Advisors Act of 1940, http://www.law.uc.edu/ccl/xyz/sldtoc.html.

[57] Rule 202(a)(1)-1, *Certain Transactions Not Deemed Assignments* promulgated under the Investment Advisors Act of 1940, http:/www.law.uc.edu/ccl/xyz/sldtoc.html.

[58] *Regulation S-P, Privacy of Consumer Information*, 17 CFR Part 248, Release No. IA-1883 (Jul. 1, 2001).

According to Commission speeches, their examinations into the privacy rule are focused on the "safeguard rule".[59] This rule requires that any entity registered with the Commission adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of client records and information. The policies must particularly assure the security and confidentiality of client records and information, protect against any anticipated threats to the security of the client records and information, and protect against unauthorized access to or use of client records or information that could result in the substantial harm of or inconvenience to any client.

Client information and files must be secured in locked files or a room to which no one other than advisory personnel have access. The protection of these records from unauthorized access and manipulation is also an area in which the Commission often sees failure. It is imperative that access is only allowed to those persons authorized to view the information.

As noted, it is not enough to merely adopt a privacy policy, but it must also be disclosed to the clients. It should be issued to clients upon engagement, preferably as an attachment to the client agreement, and again annually. This imparts knowledge to the client that the firm is required to, and is in turn protecting, their financial privacy.

Books & Records

Though books and records requirements have existed[60] for some time, these requirements continue to be a major area of enforcement by the Commission. As a result, there is no shortage of Commission speeches and statements concerning the shortcomings it finds most often.[61]

The Commission requires that investment advisors not only maintain, but maintain in an accessible place, all required books and records, including e-mails, for examinations. This requirement is often ignored by advisors, leading to enforcement letters concerning the failure of the firm to have accessible records. Accessible for the purpose of prompt production to Commission staff has been described by the staff. Something required to be accessible should be available to on-site examiners on the same day that it is requested.

The records must be kept for the required amount of time, which ranges from three to six years dependant upon the type of record. This requirement makes it necessary to store electronic items, such as e-mail, someplace where they will not be over written in a matter of months. Some of these "older" items may be stored off-site.

Through speeches, the Commission has identified those areas in which they most often find deficiencies with recordkeeping. Lack of the advisor's ability to promptly produce records is perhaps the most common complaint of Commission examiners.[62] An advisor that fails to

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[59] Mary Ann Gadziala, Associate Director, Office of Compliance Inspections and Examinations, Remarks at Books and Records Compliance Countdown (Mar. 24, 2003), modified Apr. 3, 2003.

[60] Rule 204-2 *Books and Records to be Maintained by Investment Advisors*, Investment Advisors Act of 1940, http:/www.law.uc.edu/ccl/xyz/sldtoc.html.

[61] Gadziala, *supra* note 59.

[62] Richards, *supra* note 38.

promptly produce records is considered high risk. This stance translates into the prospect that the firm will be subject to more frequent and more intense examinations, which is something any advisor prefers to avoid. Financial records are another frequently cited complaint regarding investment advisor records, such as the failure of the firm's accounting records to reconcile and noncurrent financial statements.[63]

Finally, lack of retention of a number of types of documents, specifically cash receipts and disbursement journals, correspondence with clients, and performance advertising backup materials rated high with the Commission as items often ignored by advisory firms. The rule requires that most items regarding the advisory business be maintained, and based on the focus of the Commission on the recordkeeping rule, it seems prudent that should there be question as to whether the Commission would want to review a record, it should be maintained.

The first thing an advisor should do is obtain a chart of, or the actual recordkeeping rule, and check that all items are maintained for the correct number of years and in the right place. For example, attorneys often prefer to keep minute books in their offices, but for advisors, minute books must be maintained on premises. It is best to get the firm's minute books in-house before an examination, when your corporate attorney may be unavailable.

Electronic Record Maintenance

Although the electronic recordkeeping Rule was promulgated in 2001,[64] it is still not completely understood or adhered to by all advisory firms. The amended recordkeeping rule, allowing for electronic recordkeeping, requires that the records be arranged and indexed in such a way that permits easy access and retrieval of a particular record. The firm also has to be able to promptly provide the records to the Commission, regardless of the medium of the storage.

Further, the Rule was amended to include special requirements for electronically stored information and written procedures must be adopted to that effect. Information stored electronically must be done in a manner that will reasonably safeguard the information from loss, alteration, and destruction. To this end, access must be limited to only properly authorized personnel and the Commission. The procedures must also ensure that any reproduction of non-electronic records on electronic media is complete, true, and legible when retrieved. Seemingly, the amendment regarding electronic storage merely allowed for the storage of records by that medium, and applied all of the prior requirements to that medium, with the addition of requirements that ensure their authenticity.

Electronic retention of e-mails causes the most trouble. The firm must have procedures in place to store electronic communications, so the following occurs:

- The Chief Compliance Officer may review the communications.
- The e-mails must be indexed and easily accessible to the Commission.

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[63] *Id*.

[64] Rule 204-2(g), *Books and Records to be Maintained by Investment Advisors, Micrographic and Electronic Storage Permitted*, promulgated under the Investment Advisors Act of 1940, http://www.law.uc.edu/ccl/xyz/sldtoc.html.

- Any other requirements of the electronic recordkeeping rule are met.

Although some firms are storing e-mails manually on servers, that method relies on the managers to retain everything. It also requires a manual index system be imposed. Finally, the Chief Compliance Officer has to go through this "manual" system in some manner to review correspondence.

Most firms, especially larger firms, have implemented electronic software to save and store e-mails electronically.[65] Then, some assurance exists that all e-mails are retained. Also, the Chief Compliance Officer has one place from which to review correspondence.

Most firms are mandating that only firm correspondence be sent through the firm's system. Personal e-mails must be sent through another account in Hotmail or Yahoo. Instant messaging is prohibited because of the inability to capture it automatically. Finally, most firms prefer to discourage personal e-mails at the office.

DISCLOSURES

Disclosure accuracy is an area targeted by Commission examiners.[66] In fact, disclosure problems are the most frequent deficiency cited by Commission examiners. Advisors are not being cited as much for their actual underlying activities as the simple failure to disclose those activities to regulators and clients.

The first item reviewed by examiners will be the Form ADV which they use to provide threshold insight into a firm's business.[67] It is wise to ensure that the examiners do not encounter any surprises after having reviewed the Form ADV in comparison to the actual business records. If the examiners do uncover items that are not disclosed, it will only increase the scrutiny with which they conduct the examination and the length of the deficiency letter.

Initially, advisors must disclose their investment process, analyses and how they determine investments suitable to clients.[68] Research, screening methods, criteria and other methodologies are disclosed in Form ADV. The Commission wants assurances that the "throw the dart" approach is not in use.

Advisors have a special fiduciary duty[69] to their clients, meaning that the advisor must conduct the client's affairs in the client's best interests with the same loyalty and care that the advisor would use for its own affairs. This duty requires that the advisor disclose to the client any and all conflicts of interest that may be present in the advisory relationship. This disclosure is to

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[65] Southall, *supra* note 12.

[66] Richards, *supra* note 38.

[67] Lori A. Richard, Director, Office of Compliance Inspections and Examination, Testimony Concerning the Securities and Exchange Commission's Examination of Mutual Fufare, Before the Senate Committee on Banking, Housing and Urban Affairs, March 20, 2004.

[68] Lori A. Richards, Director, Office of Compliance Inspections and Examination, Put the Compliance Rule to Work, IA Compliance Best Practices Summit, March 15, 2004.

[69] *S.E.C. v. Capital Gains Research*, *supra* note 33.

be made in the Form ADV, Part II that is given to prospective and current clients. The disclosure of such conflicts must discuss any potential conflicts in the advisory relationship, the advisor's business and fees.

The following specific items are all required to be disclosed on the Form ADV, Part II.[70] In most cases, the disclosure must describe the policy to the client, as well as indicate a person from whom they can request a copy of the policies and procedures.

- Business Continuity Plan,
- Code of Ethics,
- Privacy Policy, and
- Proxy Voting Policies and Procedures.

Other subject matters discussed in operational terms must be disclosed in Form ADV, Part II. The firm's method of selecting and recommending brokers must be described in detail, as well as trading practices and soft dollars. Any and all potential conflicts must then be disclosed.

Part II must disclose all material information for a client to make an informed decision whether to engage the advisor.[71] Of course, delivery of Part II[72] is imperative to allow that decision, and attaching it to the client agreement assures delivery and recordkeeping. The Commission frequently cites advisors for failing to maintain records of delivery of Part II, the annual offer to deliver Part II and any request for and delivery of Part II.[73]

CONCLUSION

This paper summarizes the top items, rule changes and possible areas of enforcement. Of course, many other issues exist, including the lack of clarity. Advisors are swimming in a pool of compliance requirements; implicit in the title is a sense of drowning and lack of direction. Consequently firms have unknown and known compliance duties. As always, the unknown is the worst.[74]

The Commission announces its rigorous efforts[75] to pursue enforcement action, fails to clarify its standards, and strongly criticizes advisors in examinations. Although an advisor may or may not get one free pass in its first deficiency letter, the second deficiency letter on repeat

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[70] *Regulation S-P*, *supra* note 58; Rule 204A-1 *Code of Ethics*, *supra* note 7; Rule 206(4)-6(b) and (c) *Proxy Voting*, *supra* note 32.

[71] *Section 210, Disclosure of Information by the Commission,* Investment Advisors Act, http://www.law.uc.edu/ccl/xyz/sldtoc.html.

[72] *Rule 204-3(b), Written Disclosure Statements*, promulgated under the Investment Advisors Act of 1940, http://www.law.uc.edu/ccl/xyz/sldtoc.html.

[73] Section 210, *supra* note 71.

[74] Sara Hansard, *Some small advisory firms have compliance problems,* INVESTMENT NEWS, Jun. 27, 2004, *quoting statements* by Gene Gohlke, Associate Director of the Office of Examination and Oversight.

[75] Commissioner Harvey Goldschmid, Remarks before the Council of Institutional Investors, 2005 Spring Conference, April 11, 2005.

violations may contain such language as "willfully," "knowingly" and other terms providing the bases for civil penalties.[76] The penalties often must then be disclosed in Form ADV. Most importantly, the Commission intends to pursue enforcement actions against smaller firms.

With the high trust clients place in advisors, the advisors must seriously address compliance. An advisor may treat the clients in the best and fairest manner, get good returns; however, the Commission's concern is to ensure that compliance programs are in place, implemented and documented.

It is a different regulatory environment but not unexpected. After Americans lost half their savings through scandals and fraud, the U.S. Congress funded the Securities and Exchange Commission with a mandate.[77] Investors must regain their faith in the securities industry and invest their capital in the securities markets.

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[76] Section 209(e)(2)(c) *Enforcement of Titles*, the Investment Advisors Act of 1940, at http://www.law.uc.edu/ccl/xyz/sldtoc.html. This Section provides for civil monetary penalties in the amount up to $500,000 or the gross amount of pecuniary gain. Section 214 under the Investment Advisors Act of 1940 provides for criminal liability, http://www.law.uc.edu/ccl/xyz/sldtoc.html.

[77] Commissioner Paul S. Atkins, remarks before SEC Speaks in 2005, Mar. 5, 2005.