Monday, October 20
9:00 am-10:30 am

007 How to Respond to Your Financial Services Agency

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Faculty Biographies

Brian Early

Brian Early is an examining officer and team leader in the corporate compliance and anti-money laundering risk department at the Federal Reserve Bank of New York (FRBNY) in New York. Currently, he is responsible for supervising the AML/BSA examinations of various state member banks, foreign branches, and foreign agencies located within the Second Federal Reserve District.

Previously, Mr. Early served as a team leader responsible for overseeing the AML/BSA related enforcement actions issued by the FRBNY. He also served as a risk coordinator with the on-site examination team responsible for supervising the Depository Trust Company, a limited purpose trust company and member of the Federal Reserve System. Mr. Early has served in various positions at the FRBNY including bank examiner, securities trader, and team leader. His prior examination work focused on consumer compliance, operational risk, and trust and fiduciary activities.

Mr. Early received a BS from Saint Peter's College, his MBA from Pace University, and his JD from Seton Hall University's School of Law.

F. Thomas Eck IV

F. Thomas Eck IV is assistant general counsel for Capital One Financial Corporation in Mclean, VA where he serves as the primary liaison between Capital One's legal department and the office of the comptroller of the currency on consumer regulatory matters. He also provides legal advice on fair lending, mortgage lending, community reinvestment, and federal preemption issues.

Previously, Mr. Eck has served as the senior litigation counsel for Bank of America, senior trial counsel for the office of the comptroller of the currency, and general counsel for a national mortgage company in addition to beginning his career with Gibson, Dunn and Crutcher.

Mr. Eck is a member of the American Bar Association's committees on banking law and consumer financial services, and is secretary of ACC's Financial Services Committee.

Mr. Eck graduated magna cum laude with a BS from the University of Southern California. He also received his JD from the University of Southern California, where he served as chairman of the Hale Moot Court honors program.

Edward A. Mervine

Edward A. Mervine is senior vice president and general counsel of Pathfinder Bancorp, Inc. and its subsidiaries, Pathfinder Bank and Pathfinder Commercial Bank, in Oswego, NY. Mr. Mervine, as the sole in-house attorney representing all the above companies, has broad experience in responding to financial services regulators.

Philip Wellman

Philip Wellman is vice president and chief compliance officer for MassMutual Select Funds, MassMutual Premier Funds, MML Series Investment Fund, and MML Series Investment Fund II, based in Springfield, MA. He is responsible for the adequacy and effectiveness of the compliance program for the funds, including policies and procedures, regulatory matters, conflicts and risk management, and service provider due diligence.

Previously, Mr. Wellman served as senior litigation counsel for Massachusetts Mutual Life Insurance Company, a Fortune 100 company. Prior to joining MassMutual, Mr. Wellman was senior vice president and assistant general counsel at Advest, Inc. He also held the title of director with Merrill Lynch, Pierce, Fenner & Smith, Inc. Before moving in-house, Mr. Wellman practiced with Day, Berry & Howard LLP.

Mr. Wellman has moderated and participated as a speaker on panels at a number of legal and industry conferences. He is an active member of the ABA, the Connecticut Bar Association, ACC, the Investment Company Institute, and the Securities Industry and Financial Markets Association. He currently serves as the co-chair of the Trade Secrets Subcommittee of the Business Torts Committee of the ABA's Litigation Section; the immediate-past chair of the CBA's Antitrust and Trade Regulation Section; a member of the board of directors and immediate-past president of the ACC's Connecticut chapter, and a founding member of the ACC's Financial Services Committee.

Mr. Wellman received a BA with honors from Trinity College and a JD with honors from the University of Connecticut School of Law.

Resource List – Web Page Addresses

Listed immediately below are web page links to the Board of Governors of the Federal Reserve System's public web site that can be used to access various supervisory and regulatory information and publications, supervision manuals, Supervision and Regulation Letters, and public enforcement actions.

www.federalreserve.gov/publications/default.htm

www.federalreserve.gov/boarddocs/srletters

www.federalreserve.gov/bankinforeg/default.htm

www.federalreserve.gov/newsevents/press/enforcement/2008enforcement.htm

Listed immediately below are the home web page links of the Federal Deposit Insurance Corporation, National Credit Union Administration, Office of Comptroller of the Currency and Office of Thrift Supervision:

Federal Deposit Insurance Corporation:
www.fdic.gov

National Credit Union Administration:
www.ncua.gov

Office of Comptroller of the Currency:
www.occ.treas.gov

Office of Thrift Supervision:
www.ots.treas.gov

Listed below are web page links for the Office of Foreign Assets Control, Financial Crimes Enforcement Network, Federal Financial Institutions Examination Council, and Bank for International Settlements, Basel Committee on Banking Supervision.

Office of Foreign Assets Control, U.S. Department of the Treasury, Home Web Page:
www.treasury.gov/offices/enforcement/ofac

Financial Crimes Enforcement Network, U.S. Department of the Treasury, Home Web Page:
www.fincen.gov

Federal Financial Institutions Examination Council Home Web Page:
www.ffiec.gov

U.S. Banking Anti-Money Laundering Examination Manual:
www.ffiec.gov/bsa_aml_infobase/pages_manual/manual_online.htm

Bank for International Settlements, Basel Committee on Banking Supervision, Web Page:
www.bis.org/bcbs/index.htm

SEC Compliance Alert

June 2007

Dear Chief Compliance Officer:

The SEC staff conducts compliance examinations of SEC-registered investment advisers, investment companies, broker-dealers, and transfer agents to determine whether these firms are in compliance with the federal securities laws and rules, and to identify deficiencies and weaknesses in compliance and supervisory controls. This "*Compliance Alert*" letter summarizes select areas that SEC examiners have recently reviewed during examinations and describes the issues that we found. By periodically sharing this information with compliance personnel, our intent is to alert you to these issues, encourage you to review compliance in these areas at your firm, and encourage improvements in compliance and in compliance programs. We note that this document was prepared by the SEC staff.1

I. Investment Advisers/Mutual Funds

Closed-End Fund Distributions

Many closed-end funds have a policy that provides that the fund will pay periodic, level distributions to their shareholders monthly or quarterly (these policies are often referred to as "managed distribution policies"), which are designed to address the needs of investors seeking reliable periodic cash flow from their fund investment. The amount of the distribution that exceeds net investment income earned or net capital gains realized may represent a portion of shareholders' original investment. These distributions are referred to as "return of capital distributions." While a distribution may lawfully include a return of the investors' capital or net realized capital gains, the Investment Company Act of 1940 requires that funds provide a written statement to shareholders about the source of the distribution whenever the distribution comes from a source *other* than the net investment income earned by the fund.2 The written statement must be provided *contemporaneously* with the distribution.

During examinations of closed-end funds, examiners noted that many funds that paid a return of capital to their shareholders had not sent shareholders an appropriate written "Rule 19a-1" notice along with distributions that included a return of capital component. Failing to disclose the source of the distribution may cause the fund's "distribution yield," a common performance metric used by closed-end funds in marketing (e.g., on fund websites, in press releases, and in communications providing data to third-party information disseminators) to be misleading. A high distribution rate largely comprised of return of capital might cause investors to erroneously conclude that the fund is generating a high total return. If the fund maintains a set distribution rate, the fund's CCO and board should consider whether the fund is describing effectively the fund's sources of distributions (e.g., a fund maintains a distribution rate (based on NAV) in excess of the fund's long-term historical average annual total return (based on NAV) and the fund's shares trade at a premium). The staff did note that all funds examined had provided an Internal Revenue Service Form 1099-DIV to shareholders (within 31 days of the end of the calendar year) that disclosed the portion of the distributions for the year that were characterized as return of capital. This calendar year-end disclosure, however, does not satisfy the statutory and rule requirements.

Performance Advertising Deficiencies

During a risk-targeted examination review of performance advertising by several registered investment advisers, examiners identified a number of deficiencies with respect to the advisers' advertisements of their performance returns for client accounts.3 The most common deficiency was that many advisers did not include in their advertisements the disclosures necessary to prevent their advertising from being misleading. For example, among other things, firms did not: deduct advisory fees from performance results; disclose whether results reflected dividends; and disclose differences with the particular index used to benchmark performance claims. Also, many of the advisers had inappropriately advertised their partial list of past specific recommendations.

In addition, about a third of the advisers lacked any compliance policies and procedures governing marketing and performance advertising, and others maintained procedures that did not appear to be effective. For example, inadequate policies and procedures did not:

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

Some examples of policies and procedures in place at the firms with fewer deficiencies included:

- a multi-level review process among an adviser's performance group, portfolio managers, and marketing group for the accuracy of marketing materials prior to their use;
- the creation of "tolerance reports" on a monthly basis to compare all composite accounts to their respective benchmarks, with any material discrepancies being investigated;
- a composite committee review of all accounts on at least a quarterly basis to ensure proper composite construction and maintenance; and
- the use of a second independent pricing service to periodically verify the accuracy of prices supplied by the primary pricing service, with any material discrepancies in prices being investigated.

About a quarter of the advisers examined used some type of "hypothetical return" number in their performance claims, though most coupled the hypothetical return with supplemental explanatory disclosure. Examiners identified several composite construction issues and noted limited instances where advisers had inappropriately advertised a prior adviser's performance record as its own. Examiners found that inadvertent errors in the calculation of performance results appear to have been reduced by the increased use of automated software programs to calculate performance.

A very common deficiency was with respect to advisers' inappropriate claims of compliance with the *CFA Institute's* performance presentation standards. The majority of the advisers examined during these risk-focused examinations claimed that they had presented their performance in a manner that was consistent with the *CFA Institute's* performance presentation standards, though only one was in full compliance. This was a common deficiency even though most of the advisers that claimed compliance with the *CFA Institute's* performance presentation standards had previously had their calculations and methodology "verified."

Mutual Funds' "As-Of" Transaction Practices

During examinations of mutual funds to assess their policies and procedures for processing "as-of" transactions, examiners found that some funds' policies and procedures appeared to be inadequate to mitigate the risks inherent in as-of transactions.4 Although as-of trades may provide a means to correct legitimate errors made in processing fund share orders, such trades may also serve as a vehicle for improperly executing transactions at an earlier day's more favorable NAV. In addition, purchase transactions that receive a lower than current NAV, or redemption transactions that receive a higher than current NAV, dilute the share value of other investors' holdings. Because of this potential, funds' policies and procedures should be crafted to ensure appropriate monitoring of dilution and to prevent or discourage abusive trading practices using as-of trades.

Examiners found that several fund complexes allowed intermediaries to enter as-of transactions through an investment network system, but only one of these complexes had implemented effective control procedures to review the legitimacy of the reason codes selected by intermediaries. Also, some funds had inadequate or no procedures for monitoring the cumulative effect on NAV of as-of trades. Examiners found that the boards of directors at a few funds had not reviewed or approved their funds' overall policies and procedures for processing fund shares.

Many funds did not adopt control procedures expressly requiring their transfer agent to maintain documentation of the reason for allowing an as-of transaction, or retain correspondence relating to an as-of transaction. Examiners also found instances where as-of processing was unnecessarily delayed a day or more after receiving the as-of transaction request in good order (or becoming aware that a processing error required an as-of transaction).

Advisers' Disaster Recovery Plans

Examinations of investment advisers located in Louisiana and Mississippi that were affected by Hurricane Katrina in August 2005 indicated "lessons learned" by advisers' implementation of their Disaster Recovery Plans.5 Most of the advisers examined had a written Disaster Recovery Plan in advance of the hurricane, and most but not all of those Plans addressed hurricanes/flooding. All of the firms had to relocate their business operations as a result of Hurricane Katrina. On average, firms relocated 330 miles away from their original office space, and all of the firms were able to conduct general business operations at their temporary location for an extended period of time. On average, firms were able to resume trading and manage accounts within 32 hours of the hurricane, and to resume general operations within five days of the hurricane. Most, but not all firms were able to immediately access their electronically-maintained business records and client data from their remote location. This was accomplished through the use of remote servers, laptop computers, back-up data tapes, Internet access and online trading platforms. Some firms had to physically retrieve their server from their original office space in the days/weeks after the hurricane.

Most firms maintained communication with their clients via email and the firm's website. Many firms utilized cell phones for communication, primarily via text messaging, rather than traditional voice calls. None of the firms reported clients having difficulty accessing their funds

or initiating transactions in the days and weeks following Hurricane Katrina. Most firms reported that in addition to contacting the adviser, clients could contact their custodian directly to access funds and initiate transactions. None of the firms reported receiving any client complaints as a result of client dissatisfaction with the adviser's operations or client service in the days and weeks following Hurricane Katrina.

Particular provisions of the advisers' Disaster Recovery Plans that appeared to be effective with respect to the adviser's ability to provide uninterrupted advisory services to clients in a compliant manner after a disaster included:

- a pre-arranged remote location for short-term and possible long-term use;
- alternate communication protocols to contact staff and clients, such as cell phones, text messaging, web-based email accounts, or an Internet website;
- remote access to business records and client data through appropriately secured means that ensure ongoing compliance with Regulation S-P and other confidentiality requirements;
- temporary lodging for key staff where necessary as a result of a relocation of the firm;
- maintaining accurate and up-to-date contact information for all third-party service providers, including custodians, broker-dealers, transfer agents, pricing services, and research firms;
- familiarity with the business continuity plans of such third-party service providers;
- contingency arrangements for loss of key personnel, such as the president or primary portfolio manager, either temporarily or permanently;
- effective training of staff on how to fulfill essential duties in the event of a disaster, including compliance matters;
- periodic testing, evaluation, and revision of disaster preparedness plan; and
- maintaining sufficient insurance and financial liquidity to prevent any interruption to the performance of compliant advisory services.

II. Broker-Dealers

Sales of Section 529 College Savings Plans

During examinations of broker-dealers that sold 529 College Savings Plans to retail investors, examiners found that many firms appeared to lack adequate written supervisory procedures or supervisory processes to review the 529 Plan transactions and customer accounts.6 For example, in many instances, there was little or no evidence that supervisory principals had performed a supervisory review of the suitability of recommendations to customers with respect to 529 Plans, the underlying investments in the account, and the expected duration of the investment. In addition, the manner in which the broker-dealer created or maintained its records did not facilitate supervision, including review of transactions. For example, at many firms, many 529 Plan transactions were not entered into any computer system. Consequently, those transactions did not appear on the broker-dealers' trade blotters and bypassed most exception reports. As a result, those transactions bypassed crucial aspects of the firms' supervisory systems and procedures.

Examiners found that most 529 Plans sold by the firms examined were sold to out-of-state residents. As investors who purchase an out-of-state 529 Plan may not receive some or all of the state tax benefits or may be subject to certain state income tax penalties, the tax treatment of purchasing out-of-state plans may be relevant to a suitability inquiry. Examiners did find that disclosure provided to investors in 529 Plans appeared to meet legal requirements.

Finally, it did not appear that firms had incorporated training for registered representatives or supervisors with respect to the specific factors that could impact the suitability of the firms' recommendations with respect to 529 Plans.

Sales of Collateralized Mortgage Obligations

In several examinations of broker-dealers that sold collateralized mortgage obligations (CMOs) and asset backed securities to retail customers, examiners identified deficiencies in the disclosures provided to customers and in other areas.7 The broker-dealers examined had sold some of the most complex and riskiest classes of securities to their retail customers. In some cases, the firms did not provide investors with NASD-required educational materials. At other times, firms presented investors with sales literature that appeared to be unbalanced and misleading concerning the risks and yields of the securities, and that generally minimized the risks of the securities.

A few of the firms had not provided their advertisements and sales literature concerning CMOs to the NASD for its required review and approval prior to use, or failed to respond adequately to NASD's comments prior to using sales material. These firms disseminated information which did not appear to provide balanced and complete disclosure of the risks inherent in the CMOs that were sold.

Examiners also found a lack of supervisory procedures to review the adequacy of disclosures made to investors in connection with the sale of CMOs, indications of recommendations that retail customers purchase CMOs that appeared to be unsuitable (e.g., transactions that were inconsistent with the customer's stated investment objectives and, in some cases, represented a significant portion of the customer's liquid assets), and in some instances, undisclosed markups that appeared to be excessive.

Sales of Real Estate Investment Trusts

Examinations of broker-dealers that sold real estate investment trust (REIT) products indicated deficiencies of several types.8 The examinations concentrated on the sales of unlisted public REITS to retail investors, which have grown in popularity in recent years. Examiners found indications of inadequate and potentially misleading disclosures to investors concerning the risk of the investments, the possible future public trading market for the REITs, and their liquidity. Examiners also noted deficiencies relating to the valuation of the investments in REITs, the source of dividend payments, sales of the securities prior to registration, lack of supervision over registered representatives selling REITs, and potential conflicts of interest arising from excessive non-cash compensation paid by sponsors of the REIT to the broker-dealer and/or its sales force.

Supervisory Procedures to Ensure Compliance with Regulation SHO

Recent examinations indicated deficiencies with respect to compliance with Regulation SHO.9 Specifically, many firms did not have adequate written supervisory procedures to ensure compliance with the Rule. Some of the firms examined appeared to have incorrectly marked short sales and long sales, many firms did not have procedures or a system to monitor whether

long sales were resulting in fails to deliver, and some firms did not perform a locate or adequately document a locate prior to the execution of a short sale. Examiners found that many firms did not close out fail to deliver positions within thirteen consecutive settlement days (though the number of incidents found was quite small). Some firms allowed additional short sales in a security without pre-borrowing when a fail to deliver position remained for more than 13 consecutive settlement days.

Charges in Separately Managed Accounts

During examinations of some broker-dealers that offer separately managed accounts (SMAs), examinations found instances where customers had been overcharged for SMA fees in a significant number of customer accounts.10 In these instances, charges assessed to customer accounts were inconsistent with the charges outlined in the customer agreements, with breakpoint discounts, and/or with offering documents. These firms appeared to lack sound control procedures to ensure that the fees assessed to customers were consistent with the charges outlined in customer agreements and offering documents.

Part-Time Financial and Operations Principals

NASD Rules require all broker-dealers to have a Financial and Operations Principal who is responsible for the final preparation and accuracy of financial reports submitted to securities regulators and the supervision of individuals who assist in the preparation of such reports and who maintain the firm's financial books and records. During examinations of broker-dealers employing part-time Financial and Operations Principals (so-called "Rent-A-Finops"), examiners reviewed the firms' compliance with books and records and minimum financial requirements under the broker-dealer financial responsibility rules and found that some firms appeared to have inaccurate books and records, which resulted in erroneous financial reports to regulators.11 The inaccuracies included the understatement of liabilities, erroneous net capital computations, and net capital deficiencies. Examinations also found that many Rent-A-Finops had no role in the actual supervision or the creation and maintenance of various books and records, as required by NASD Rules. Examinations further indicated that some Rent-A-Finops may be overextended (some were registered at more than 15 firms simultaneously). .

Expense-Sharing Arrangements

During targeted examinations of select broker-dealers that utilize expense-sharing agreements, examiners noted various deficiencies, including indications that some firms operated while failing to maintain required minimum net capital. These deficiencies were caused by the inappropriate shifting of a liability from the broker-dealer to an affiliate.12 Examiners also found that some firms had failed to maintain adequate expense-sharing agreements.

SEC Compliance Alert

July 2008

Dear Chief Compliance Officer:

The SEC staff conducts compliance examinations of SEC-registered investment advisers, investment companies, broker-dealers, and transfer agents and other types of registered firms to determine whether these firms are in compliance with the federal securities laws and rules, and to identify deficiencies and weaknesses in compliance and supervisory controls. This "*Compliance Alert*" letter summarizes select areas that SEC examiners have recently reviewed during examinations and describes the issues we found and some of the practices we observed. By periodically sharing this information with compliance personnel, our intent is to alert you to these issues, encourage you to review compliance in these areas at your firm, and encourage improvements in compliance and in compliance programs. Some of the practices we discuss are for informational purposes, are not legal requirements, and, depending on the characteristics of your firm, may not be practicable for your firm to implement given its business or operations. We note that this document was prepared by the SEC staff.

I. Investment Advisers/Mutual Funds

Personal Trading by Advisory Staff

Personal trading by access persons is an area of focus during many examinations of investment advisers. Specifically, examiners review an adviser's internal compliance controls surrounding its employees' trading and trading by the firm for its own proprietary accounts. Deficiencies frequently identified by examiners include:

- *Adviser's code of ethics was incomplete.* The adviser's code of ethics did not appear to address all regulatory requirements. For example, examiners have commented when firms' codes of ethics do not require access persons to obtain pre-approval before investing in certain limited investment opportunities (*e.g.*, private placements, hedge funds, or initial public offerings).
- *Adviser's code of ethics was not followed.* The adviser and/or its employees engaged in practices that deviated from the adviser's written code of ethics (*e.g.,* trades were not pre-cleared, pre-clearance forms did not contain information required to be provided by the employees, the adviser did not receive duplicate confirmations, and trades were placed in securities that are on the adviser's "do not trade" list). Examiners also commented when they believe an adviser had weak control procedures regarding oversight of supervised investment personnel (*i.e.*, portfolio managers, traders, and analysts), such as when these personnel disclosed sensitive portfolio and trading information to advisory personnel at other advisory firms, which were managing the supervised personnel's money in hedge funds or separate accounts.
- *Reporting requirements were not followed and/or monitoring was not performed.* Access persons did not submit, or did not submit in a timely manner, reports of their personal securities transactions or holdings consistent with applicable regulations or the adviser's policies and procedures. Also, some advisers did not review reports of access persons' personal trading for indications that trades were inconsistent with applicable regulations

or the adviser's policies and procedures.
- *Disclosure was inaccurate.* The adviser's brochure appeared to contain inaccuracies with respect to its controls over personal trading.

Examiners recently conducted a risk-targeted examination review that focused on advisers' compliance practices and internal controls with respect to access persons' personal trading and trading in proprietary accounts. In addition to firms establishing procedures to ensure compliance with specific regulatory mandates, examiners observed that the following practices appeared to be effective in assisting in preventing violations of the Advisers Act:

Internal Compliance Controls

- Written policies and procedures were designed to address conflicts of interest with respect to trading in personal and proprietary accounts.
- Restricted lists and watch lists were accurate and maintained on a current basis. Time-stamped order tickets were utilized.
- To enable centralized monitoring of all trading, all personal securities transactions were effected through the adviser's trading desk.
- Trades in client accounts were consistently bundled with, or executed prior to, trades in personal or proprietary accounts.
- "Black-out" periods, during which access persons are not permitted to execute personal securities transactions, were strictly enforced.
- Access persons were prohibited from engaging in short-term trading (*i.e.*, the purchase and sale of a security within 60 days).
- Any exceptions from the policies stated in the adviser's code of ethics that were granted to supervised persons were reasonable and documented.
- Access persons were required to direct their broker-dealers to provide duplicate trade confirmations and copies of monthly brokerage statements to the adviser.

Compliance Review and Reporting

- Trade allocations were determined prior to or soon after the trade was executed. Any post-execution changes to trade allocation were documented and reviewed by an appropriate individual to ensure that the allocation was consistent with the adviser's policies and procedures.
- Documentation of pre-approval of personal securities transactions was created at the time of the approval and was maintained. In addition, pre-clearance forms prepared by access persons were subsequently compared to the actual trading in those persons' accounts.
- Procedures were in place to ensure that trading does not occur in client accounts, employee personal accounts, or the adviser's proprietary accounts while the adviser or its employees are in possession of material, non-public information pertaining to that security. Information barriers are in place to prohibit the flow of such information. These conflicts of interest were addressed in the adviser's written policies and procedures. Examiners especially focus on these procedures when a related person of the adviser also serves on the board of directors for an issuer and, therefore, may have access to non-public information.
- Performance of client accounts was compared to the performance of personal and firm proprietary accounts employing similar investment strategies for any indications of preferential treatment.
- Personal and proprietary securities transaction records were maintained electronically so that analyses could be more efficiently performed and outlier issues researched. Examples of analyses included, identifying when a high percentage of personal trades for an access person were profitable (in absolute terms and in relation to clients) or identifying when a personal trade resulted in exceptional returns.
- Prices were adjusted if, on the same day, trades in related accounts were executed at a better price than client accounts.
- The reviewer of personal securities transactions had his or her own personal securities transactions reviewed by another officer or control person of the adviser.
- Supervised persons who violated or continued to violate the adviser's policies and procedures with respect to trading in personal or proprietary accounts were reprimanded.
- The adviser periodically reported code of ethics violations to funds' boards of directors and provided prompt notice of any serious violations.

Examiners noted that, at many of the advisory firms that appeared to have effective compliance programs in this area, compliance personnel were actively involved in implementing those programs. For example, the compliance department implemented policies and procedures for personal securities transactions and trading in proprietary accounts and ensured that all employees were aware of the advisers' polices and procedures. Further, compliance personnel not only provided employees with the firm's code of ethics as mandated by the regulations, but expanded on the regulatory requirements by ensuring that firm employees received training in the adviser's policies and procedures and requiring firm employees to acknowledge each year, in writing, that they had *read* the adviser's code of ethics.

Proxy Voting and Funds' Use of Proxy Voting Services

Examiners recently reviewed practices with respect to the use of third-party proxy voting services, including the oversight and operational aspects of mutual funds' proxy voting, and how advisers managed conflicts of interest in proxy voting. The services performed by the third-party proxy services included the following: processing proxies for fund clients; managing and tracking proxy voting on securities held in client accounts; filing Form N-PX; report generation for reconciliation purposes; vote recommendations; research; and casting actual votes using the firms' or the service providers' guidelines. The most frequent service provided by a proxy voting service was the management of the administrative aspects of proxy voting. Some services were highly specialized. For example, a proxy service may be engaged solely to vote when the adviser has a material conflict of interest.

Proxy Voting Oversight and Operations

The funds examined typically had an oversight process, which included board participation, to monitor the funds' proxy voting. Among other things, examiners confirmed that fund boards reviewed and ratified the funds' proxy voting policies annually and analyzed significant changes. Typically, the boards received a copy of the funds' voting record on Form N-PX. Several advisers elected to establish a proxy voting oversight committee to monitor the proxy voting process and to ensure their proxy voting procedures were followed.

Most advisory firms had adopted policies and procedures with respect to proxy voting as required under the proxy voting rule. However, in some instances, examiners discovered that the proxy voting policies and procedures seemed to contain inaccurate information or were not followed. In other instances, the firm could not say whether it voted on several matters or

whether an accurate record of those votes was recorded on Form N-PX. Some deficient practices highlighted by examiners included:

- *Board oversight of use of proxy service providers appeared to be weak.* In some instances, the funds had neither established controls to confirm that the proxy service providers' recommendations were consistent with funds' policies and procedures nor requested information regarding conflicts of interest at the proxy service providers.
- *Advisers did not document their assessment of proxy service providers.* Some firms had not documented their review of the proxy service providers used; therefore, examiners could not assess whether the adviser had established and implemented measures reasonably designed to identify and address proxy voting firms' conflicts of interest. Examiners also could not confirm claims of proxy service provider independence.
- *Funds voted inconsistently with their proxy voting policies.* Funds attributed these mistakes to clerical errors or misapplication of fund voting guidelines to specific votes.
- *Funds did not file Form N-PX containing the funds' proxy voting record as required.* In several instances, firms did not include a record of all votes cast on Form N-PX. In other instances, proxies were not included on Form N-PX because they were never voted or funds did not meet the specific requirements of Form N-PX. For example, the form requires funds to briefly identify the matter voted on. Firms sometimes used vague descriptions of votes that did not succinctly describe the proxy matter or the fund's vote on the matter.
- *Fund disclosures appeared deficient.* Several fund groups did not include the necessary disclosures in their Statements of Additional Information regarding the availability of the proxy voting policies and procedures, as required by Form N-1A.

- *Improper fees were charged.* An adviser allocated proxy service fees to funds, purportedly for services rendered, which did not hold voting securities that would require such services. Another adviser used soft dollars to pay for proxy voting services unrelated to issuer research without adequately disclosing this practice.

Process for Identifying Potential Conflicts of Interest

An adviser might have a conflict of interest between its business interest and the interests of its clients and shareholders. The firms examined generally had a process to identify conflicts of interest with respect to proxy voting. Often firms relied on the fund's chief compliance officer, the adviser's proxy coordinator, or other advisory employees to identify such conflicts. The proxy coordinator was often a senior employee knowledgeable about potential conflicts of interest that may exist between the adviser and its clients. These processes generally appeared to be effective.

Valuation and Liquidity Issues in High Yield Municipal Bond Funds

Many high yield municipal bond funds invest in securities that trade in the secondary market on an infrequent basis or never trade in the secondary market. Market quotations for such securities are often not considered to be readily available. Such limited market activity usually results in the funds' boards determining the fair value of these instruments for net asset value purposes, often considering pricing services' evaluated prices. Further, liquidity determinations for a high yield municipal bond fund are critical to ensure that the fund is able to redeem fund shares within seven days, as required under the Investment Company Act.

During these examinations of high yield municipal bond funds, examiners generally focused on portfolio composition, valuation, and transaction activity. Specifically, examiners: analyzed the credit quality of portfolio holdings; reviewed illiquidity levels as determined by fund management; compared sales prices to prior day valuations; compared bond valuations provided by pricing services to market transaction data; reviewed fund policies and procedures relevant to security valuation and determinations of liquidity including, where applicable, board oversight of those policies and procedures; reviewed portfolio credit and research files; and interviewed compliance and advisory personnel regarding policies and procedures and internal controls relevant to valuation and liquidity determinations.

During a series of targeted examinations focusing on high yield fund valuation, examiners noted the following:

- *Portfolio composition.* High yield funds with higher average credit qualities, fewer unrated securities, and fewer distressed and defaulted securities were generally less likely to have issues regarding valuation and liquidity raised by examiners. The percentage of illiquid securities held among the funds examined ranged from less than 1% to 70% of the fund's portfolio holdings. Examiners particularly focused on whether funds may have been overvaluing securities classified as illiquid.
- *Disclosure.* High yield funds often did not disclose the increased risk with respect to liquidity and valuation, as required. For example, examiners commented in situations where the percentage of illiquid securities held by a fund dramatically increased and the fund did not disclose: that a dramatic increase in the percentage of the fund invested in illiquid securities occurred and the risks associated with such an increase; what effect, if any, the increase may have on the fund's ability to redeem investor shares in a timely manner consistent with the federal securities laws; and what steps, if any, the fund may take to dispose of some of the illiquid securities to bring the percentage within a range appropriate to the circumstances.
- *Third-party pricing services.* Pricing services often relied on fund management to provide information needed to value securities held by high-yield funds. Examiners commented that the fund's disclosure may be misleading if, in such instances, the fund represented that its pricing source provided "independent" values. Examinations revealed that pricing services relied on fund management to provide information at times, which may have resulted in stale review periods and stale valuations for a number of Rule 15c2-12 exempt securities. In addition, some funds were unable to sell securities at approximately the evaluated prices provided by a pricing service. Examiners may comment if the fund's board does not consider this information when subsequently evaluating the accuracy of the evaluated prices provided by the pricing service.
- *Cross trades.* An adviser's trading of securities among client accounts can create risks that securities will be "dumped" from one client account to another, that the securities may be mispriced because they are not traded in the open market, or that one client may otherwise be disadvantaged. The few funds examined that entered into cross trades of securities for which there was no secondary market information were unable to provide examiners with documentation supporting their determination that the evaluated prices provided by the pricing services and used to cross the trades sufficiently represented market values (*i.e.*, trade execution data, the latest bid and ask quotes, and information

about offerings of similar securities).

- *Board oversight.* It appeared that some funds did not adequately assess the accuracy of prices provided by pricing services. Examiners noted that some high yield funds' with effective valuation procedures required documentation and review of communications between portfolio management personnel and pricing services. The review of such communications can serve to detect and prevent inappropriate influence by portfolio management personnel over the valuation process and would substantiate the independence of a third-party pricing service.
- *Records retention.* The manner in which some high-yield funds chose to maintain their pricing histories for portfolio securities created difficulties for the personnel responsible for the high-yield funds' pricing, and for boards of directors, to determine trends in price movements. Specifically, while not required, examiners have noted that funds' compliance reviews using electronic records allow for more efficient analysis and review of fund records for valuation anomalies and patterns requiring further research.

Soft Dollar Practices of Investment Advisers

Examiners recently reviewed the soft dollar arrangements maintained by a number of registered investment advisers. The focus of these examinations was to gain a better understanding of: the extent to which advisers to institutional clients, including hedge funds, use soft dollar arrangements to obtain third-party and/or proprietary services or products; the disclosures advisers provide to their clients regarding soft dollar practices; and the policies and procedures that advisers who receive soft dollar benefits use to meet their fiduciary duty to seek best execution.

In reviewing soft dollar transactions, examiners generally review arrangements that an adviser may have with both third-party and proprietary providers. Generally, examiners will review documents and information regarding the adviser's policies and procedures related to brokerage, trading, and soft dollar arrangements. In addition, examiners will consider the identity of broker-dealers and service providers used and the products and services received from them, as well as trade journals, commission runs, disclosure documents, investment advisory contracts, any written agreements relating to soft dollar arrangements (including commission sharing arrangements), and any documentation of the adviser's periodic evaluation of execution quality.

In our recent review, examiners observed the following:

- *Products and services.* The advisers examined generally received both proprietary and third-party products and services through soft dollar arrangements with broker-dealers. Research and trade execution assistance products and services were the most common. Many advisers received "mixed-use" products or services and a few advisers received products and services outside those that are defined in the safe harbor under Section 28(e) of the Securities Exchange Act of 1934.
- *Total commissions directed.* All of the advisers examined who had soft dollar arrangements told examiners that they had informal commission "targets" with the broker-dealers who provide them with third-party or proprietary research services. Advisers stated that these commission targets were intended as guides and did not obligate the advisers to firm commitments. On average, 20% of these advisers' total client commissions were directed to broker-dealers through which the advisers earned soft dollar credits, though the percentage among all of the advisers ranged from about 3% to 100%. Commissions on transactions that earned soft dollar credits ranged from $0.01 to $0.08 per share, with an unweighted average commission rate on soft dollar trades of $0.05 per share.
- *Best execution analyses.* Most advisers documented their efforts to seek best execution, as required. Advisers typically conducted "periodic" execution quality reviews on an annual, semi-annual, or quarterly basis. To ensure consistency with regulations and internal compliance policies and procedures, many advisers chose to assign the responsibility for such reviews to brokerage or compliance committees. Examiners evaluated the quality of firms' best execution reviews, which varied – some were more detailed and comprehensive than others. Most of the advisers examined who were relying on the Section 28(e) safe harbor made determinations that commissions were reasonable in light of the brokerage and research services received, as required. Some advisers, in making such determinations, elected to regularly compare the amount they might have been "paying up" against the actual value of the research. In situations where advisers have not evaluated the value of the research received through the use of soft dollar credits and the commissions are higher than examiners would expect for the instruments traded, examiners may question whether the advisers have overpaid for such research. A few advisers accumulated large soft dollar credit balances at broker-dealers, up to millions of dollars in value. As a result, examiners analyzed further whether the commissions paid may not have been reasonable, especially when some advisers were paying higher commission rates and were not receiving products or research. For example, examiners evaluated whether an adviser had the opportunity to misappropriate client assets, such as if an adviser accepted cash rebates offered by broker-dealers for the outstanding soft dollar credit balances maintained with the broker-dealers.

- *Disclosures.* Most of the advisers disclosed the types of products, research and services received in exchange for soft dollars, as required. Advisers also generally complied with regulatory guidance by disclosing: that clients may pay commissions higher than those obtainable from other broker-dealers in return for the research, products and services; that research is used to service all accounts and not just those accounts paying for it; and, the procedures they follow when they direct client transactions to particular broker-dealers in return for products, research and services received. Most advisers complied with their obligation to disclose the existence of conflicts of interest from their receipt of research obtained with soft dollars, including the adviser's incentive to use client brokerage commissions to purchase research that the adviser might otherwise have to purchase with its own money. They also, as required, disclosed that certain products and services may have a mixed-use and the extent of the allocation between hard and soft dollars. However, examiners commented when an adviser does not disclose conflicts of interest, such as when an adviser has acquired research with soft dollar payments from a research company in which affiliated persons have an ownership interest. Examiners also commented when advisers that acquired products and services outside the Section 28(e) safe harbor, such as internet domain fees, wireless services for a Blackberry, and telecommunications and computer equipment, did not disclose this practice to clients. Examiners also may comment if an adviser expressly represented to clients that it would only engage in soft dollar arrangements within the Section 28(e) safe harbor, but nonetheless earned soft dollar credits by trading in accounts for which the adviser does not have brokerage or investment discretion.

- *Compliance policies, procedures, and/or controls.* Most advisers examined had policies and procedures related to soft dollar practices. While these policies and procedures varied

per firm, examiners noted that effective practices required the adviser to maintain reports of soft dollar arrangements and transactions, reconcile commissions on a periodic basis, review mixed-use product allocation, and ensure that its chief compliance officer or a committee approve, in advance, specific products and services acquired with soft dollars.

II. Broker-Dealers

Examinations of Securities Firms Providing "Free Lunch" Sales Seminars

As part of a focused effort to protect senior investors, FINRA, NASAA and the SEC conducted a series of over 100 examinations of broker-dealers, investment advisers and other financial services firms that offer so-called "free lunch" sales seminars. In sum, examinations observed that:

- *Sponsors of "free lunch" sales seminars offer attractive inducements to attend.* The seminars are commonly held at upscale hotels, restaurants, retirement communities and golf courses. In addition to providing a free meal, the firms and individuals that conduct these seminars often use other incentives (*e.g.*, door prizes, free books, and vacation deals) to encourage attendance.
- *Often, the target attendees are seniors.* Many of the "free lunch" sales seminars are designed to solicit seniors. They are advertised with names like "*Seniors Financial Survival Seminar*" or "*Senior Financial Safety Workshop,*" and offer "free" advice by "experts" on how to attain a secure retirement, or offer financial planning or inheritance advice. The advertisements used to solicit attendees often imply that there is an urgency to attend. For example, invitations include phrases such as "limited seating available" or "call ***now*** to reserve a seat."
- *Seminars are designed to sell.* Many sales seminars were advertised as "educational," "workshops," and "nothing will be sold at this workshop," and many advertisements did not mention any investment products. Nonetheless, the seminars apparently were intended to result in the attendees' opening new accounts with the sponsoring firm and, ultimately, in the sales of investment products, if not at the seminar itself, then in follow-up contacts with the attendees. Examiners noted that the most commonly discussed products at the sales seminars were variable annuities, real estate investment trusts, equity indexed annuities, mutual funds, private placements of speculative securities (such as oil and gas interests), and reverse mortgages.
- *Some firms had particular compliance and supervisory controls that appeared to be effective.* Regulators identified specific compliance and supervisory practices that appeared to be effective in ensuring compliance with the securities laws and rules. For example, requiring its employees to forward all materials to its home office for a supervisory and compliance review prior to using the materials at sales seminars. Another effective procedure utilized checklists to aid supervisors with the approval process for seminars and seminar materials (more detailed examples of these practices are set forth in Appendix B to the public report referenced below).
- *Half of the examinations found that firms used advertising and sales materials that may have been misleading or exaggerated or included seemingly unwarranted claims. Many broker-dealer firms did not submit their sales material to NASD (now FINRA) for review, as required by NASD advertising rules.* The most common types of apparently misleading statements appeared on mailers and advertisements for the sales seminars, and involved statements about the safety, liquidity or anticipated rates of return. Statements included, for example: "Immediately add $100,000 to your net worth," "How to receive a 13.3% return," and "How $100K can pay 1 Million Dollars to Your Heirs." Additionally, some sales materials made comparisons between dissimilar investments or services, included representations about the expertise or credentials of the registered representative that may have been misleading or confusing, or involved testimonials that may have been misleading.
- *Individuals attending the sales seminars may not understand that the seminar is sponsored by an undisclosed company with a financial interest in product sales.* The mailers and advertisements for the sales seminars often focused on the individuals who would be conducting the seminar, and often included the name of the registered representative or investment adviser, a photograph and information about his/her background as an expert in providing investment advice, and his/her history in the local community. Attendees at the seminars are not always provided with the name of the firm sponsoring the seminar, and may not be aware that product sponsors (*e.g.*, mutual fund companies and insurance companies) may provide funding for the seminars with the expectation that investment professionals will sell their products. In these situations, seminar attendees may not have known that the financial adviser speaking at the seminar was not unbiased in making product recommendations.
- *Many examinations discovered indications that firms had poorly supervised these sales seminars.* Examiners noted indications of weak supervisory practices in 65 of the 110 examinations. For example, a common finding was that firms appeared to have inadequate supervisory procedures or had not implemented their procedures with respect to sales seminars held by their employees.
- *In some examinations registered representatives or investment advisers holding the sales seminars had recommended investments that did not appear to be suitable for the individual customers.* In 25 of the 110 examinations (or 23% of examinations conducted), examiners found indications that unsuitable recommendations to purchase investments were made at the sales seminars, or following the seminar when an attendee opened an account. The investments appeared to be unsuitable in light of the customers' investment objectives or time horizon – *e.g.*, a risky investment was recommended to an investor with a "conservative" investment objective, or an illiquid investment was recommended to an investor with a short-term need for cash.
- *In some instances, the sales seminars may have involved fraud.* Examiners found indications of possible fraudulent practices in 14 examinations (or 13% of the examinations conducted), that involved potentially serious misrepresentations of risk and return, liquidation of accounts without the customer's knowledge or consent, and sales of fictitious investments.

Financial services firms should take steps to supervise sales seminars more closely, and specifically take steps to review and approve all advertisements and sales materials for accuracy. In addition, the report concluded that firms should redouble efforts to ensure that the investment recommendations they make to seniors are suitable in light of the particular customer's investment objectives, and assure that supervisory procedures with respect to sales seminars are being implemented effectively. Regulators participating in these examinations will continue to focus examination, enforcement and regulatory efforts on the use of sales seminars targeted to seniors.

The results of the examinations are described in detail in a public report entitled, *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars* (September 10, 2007), at http://www.sec.gov/spotlight/seniors/freelunchreport.pdf. The

report includes a list of supervisory practices that were identified during examinations and that appeared to be effective (Appendix B of the report).

Valuation and Collateral Management Processes

Examiners recently completed examinations of certain large broker-dealer firms to assess their valuation and collateral management practices as they relate to subprime mortgage-related products, and coordinated these valuation examinations with FINRA. The examinations generally focused on the controls around the valuation process. An important control is the verification by independent personnel of the valuations assigned by trading personnel. This independent verification function is referred to as the "product control." During the late spring and summer of 2007, examiners observed, in general, that firms faced increasing difficulty in independently verifying their inventory valuations due to a lack of market liquidity. As a result, firms have become more reliant on modeled prices as opposed to independent third party pricing services and/or transactions. Several firms revised their valuation procedures to consider more broadly observable market information by looking to trades in the derivative markets, which include single name credit default swaps and subprime mortgage-related index trades in credit default swaps, to assist in the calibration of valuations. Examiners noted the following issues during the review:

- *Price verification deficiencies.* At some firms, the product control groups employed certain processes that appeared to be of questionable merit or failed to be sufficiently vigorous in undertaking the price verification function. This included the use of outdated information in determining valuations, reliance on non-independent contributing sources for valuation determination, the failure to fully address variances, and the use of manual procedures (in contrast to the use of automated processes in the verification function, including the use of data feeds and modeling tools).
- *Insufficient staffing.* In some examinations, the independent product control groups did not appear to be sufficiently staffed, and/or were staffed with individuals with limited experience in validating modeled prices, which left them highly reliant upon trading personnel for valuations.
- *Policies and Procedures.* The policies and procedures for verifying inventory valuations were not documented; and/or, were not accurately and/or sufficiently detailed; and/or, the intended procedures as documented were not adhered to.
- *Documentation.* In some examinations, the documentation standards and practices with respect to the retention of the price verification work performed by the product control groups were not established and/or memorialized. In addition, standards were inconsistent across firms in that, some retained a substantial amount of documentation, while others recreated the supporting analysis or were unable to provide support for their independent valuations.
- *Verification of Collateral Prices.* In some examinations, the product control groups were not routinely engaged in assessing the valuation of collateral. At some firms, only the limited number of securities that were both held as collateral and held in inventory were subject to review by the product control group. At other firms, subprime securities held as collateral were solely by proprietary traders and/or outside pricing services, with no oversight by the product control group. In addition, one firm utilized prices received directly from an affiliate of two counterparties to value collateral that it was financing for those very same counterparties.
- *Inconsistent pricing.* In some examinations, there were limited instances of inconsistent pricing between the same securities held in inventory and also held as collateral for financing transactions with counterparties. These discrepancies appeared to result from limitations in data management at these firms.
- *Margin on collateral.* In some examinations, the processes surrounding the issuance and resolution of margin calls were not established, adhered to, and/or adequately documented. In some examinations, the application of margin on collateral held for financing transactions was not adequately documented in the firm's procedures and/or was unsupervised, resulting, in some cases, in variances from the firms' established procedures.

In this area, the following would be examples of strong control practices:

- The product control group at firms employ processes and procedures that are aligned with market conditions. Policies and procedures with respect to valuation contemplate the possibility of illiquid markets, and that illiquid market conditions will necessitate alternative pricing methodologies that may require the verification and assessment of modeled inputs and the calibration of valuations against trades or trade information inferred from activity in similar securities and or the derivative markets.
- The product control group is adequately staffed and includes members that have the experience, knowledge and capability of assessing the valuation of the securities they are charged to review.
- There are established standards and documentation is maintained to support the valuations appearing on their financial statements. Retention of records used in determining value helps provide the necessary audit trail and transparency that is essential to understanding the valuation of these securities. Such records include inputs to models, cash flow analyses, valuation matrix assignments, a description of third party valuation sources that were utilized, and any other relevant information.
- Independent product control groups are involved in monitoring collateral valuations by, at a minimum, including difficult-to-value positions in periodic month-end reviews.
- Firms maintain an internal data warehouse that serves as the internal repository for security position information, including periodic valuations, in order to ensure consistency amongst various inventory trading accounts and collateral valuations.
- Firms ensure that price verification, collateral management, and margin call processes and procedures are adequately documented and contain enough specificity to ensure consistent application. Furthermore, firms ensure that changes to written procedures are timely incorporated and that procedures are implemented effectively.

Broker-Dealers Affiliated with Insurance Companies

Many insurance companies have broker-dealer subsidiaries that were initially created or purchased to facilitate the sales of insurance/securities products, such as variable annuities and variable life insurance. Many of these firms have transitioned over time to become full service broker-dealers.

Examiners conducted targeted reviews of a number of broker-dealer subsidiaries of insurance companies. Examinations observed:

- *Apparently unsuitable recommendations and apparently inadequate supervisory procedures.* Some examinations identified apparently unsuitable mutual fund and/or variable annuity transactions. Examiners also discovered instances of apparent supervisory deficiencies that were primarily the result of inadequate written supervisory

procedures maintained by the firms and instances of failure to implement written supervisory procedures.
- *Financial responsibility rule deficiencies.* Examiners noted deficiencies in firms' compliance with the financial responsibility requirements for broker-dealers and identified the need for net capital adjustments.

Many of these apparent deficiencies were due to lack of compliance, operational and supervisory controls. In some cases, these firms were managed by individuals whose primary experience was in the insurance industry, and who did not appear to have a comprehensive knowledge of the rules and regulations of the securities industry.

Supervision of Solicitations of Advisory Services

Examiners conducted a series of targeted examinations of broker-dealer firms that had designated their registered representatives as "solicitors" for an investment adviser. The examinations reviewed, among other things, how supervision was implemented for these registered representatives' activities as solicitors. In general, a solicitor is the investment adviser's "salesman" to potential clients of the adviser; however, in these examinations, examiners noted that the solicitors/registered representatives were providing investment advice to customers – they were guiding the client's selection of an investment program and the underlying products in the program.

- *Lack of responsibility for suitability.* In some cases, the examinations discovered an apparent lack of supervisory controls - that is, neither the broker-dealer nor the investment adviser had assumed responsibility for monitoring the suitability of the advisory services and the suitability of recommendations of the underlying investments for the customers of the broker-dealers, or the clients of the investment adviser. In particular, examiners noted that the investment adviser attempted to delegate responsibility for performing a suitability review to the broker-dealers by contract, which created an apparent gap in the supervision between the adviser and the broker-dealer.
- *Supervision for suitability.* Several broker-dealers did not appear to fully comply with their supervisory obligations because they did not establish and/or enforce adequate written procedures to supervise solicitor activity by their registered representatives. In particular, it was often unclear whether transactions recommended to customers by registered representatives had been reviewed by a sale principal for suitability.
- *Sales material.* Some of the broker-dealer firms used apparently false and/or misleading advertising and sales literature, and apparently did not file their sales material with the NASD, and/or they failed to have a principal of the firm indicate evidence of review and approval of materials.

Mortgage Financing as Credit for the Purchase of Securities

In recent years, some broker-dealers have recommended that their customers purchase securities, and, to finance the purchase of securities, the broker-dealer has recommended that the customer obtain a second or reverse mortgage on their home through a bank affiliated with the broker-dealer. In these transactions, a risk exists that the customer may not generate sufficient returns in his/her securities account to fund the interest due on the mortgage, and that investors may risk the loss of their home.

Examiners conducted a risk-targeted examination of broker-dealer firms to evaluate this practice. Examinations noted that many of the firms had specifically prohibited their registered representatives from recommending that customers obtain loans (other than through margin accounts) to purchase securities. Examinations revealed, however, that some firms maintained incentive programs for registered representatives to refer customers to an affiliated bank for a mortgage.

- *Supervision and record-keeping.* Examinations indicated that supervision and record-keeping relating to these activities appeared to be poor. For example, some firms did not provide adequate supervision over registered representatives to ensure that they complied with the firm's policy prohibiting a registered representative from recommending that customers obtain a home mortgage to purchase securities. Broker-dealers did not have records readily available that would indicate instances where customers had obtained a home mortgage from an affiliated bank and used the proceeds to purchase securities. Absent this information, broker-dealer firms did not appear able to assess compliance with the firms' internal policy prohibiting registered representatives from recommending that customers obtain a home mortgage to purchase securities.
- *Suitability.* Examiners made comments with respect to the suitability of recommendations, as well as a possible misrepresentation about the "safety" of mortgaging a home to purchase securities by registered representatives at another firm.

Office of Supervisory Jurisdiction Supervisory Structure

Examiners conducted a targeted review of a sample of broker-dealer firms' supervisory and compliance controls under an Office of Supervisory Jurisdiction (OSJ) structure. In particular, examiners reviewed each firm's supervisory structure and practices, and its supervision of its branch offices, including the results of the firm's internal inspections.

While examinations revealed apparent deficiencies in a range of areas, the most notable pertained to:

- *Supervisory polices and procedures.* Many of the broker-dealers and OSJs examined apparently had not adopted, implemented, and/or consistently adhered to adequate written supervisory procedures. These deficiencies involved procedural and substantive inadequacies in the review of customer accounts, the handling and reporting of customer complaints, reviews of correspondence and employee accounts, annual branch inspections, and the execution of supervisory duties. These apparent supervisory and compliance deficiencies allowed indications of sales practice problems to go undetected and unreviewed by many of the firms examined. For example, examiners noted instances of Class B and Class C shares of mutual funds being recommended where it appeared that customers could have received breakpoint discounts for purchasing Class A shares, thereby raising suitability issues.
- *Record-keeping.* Examiners also discovered apparent books and records deficiencies, including failures to: prepare adequate records documenting customer complaints; prepare and maintain checks received and variable annuity trade blotters; maintain employee outside account statements; maintain or approve customer new account forms; complete order tickets; and maintain customer advisory agreements.

III. Transfer Agents

Practices with Respect to "Lost Securityholders"

When the owner of a security is "lost," transfer agents are required to exercise reasonable care to ascertain the securityholder's correct address. Under the transfer agent rules, a recordkeeping transfer agent must conduct at least two searches for the securityholder at no charge to the securityholder using at least one information database service. Once these two searches are performed, any further searches can result in the securityholder being charged for the costs associated in locating him/her.

Examinations of transfer agents were conducted in order to understand current practices with respect to the search process performed for "lost" securityholders and the use of third-party "search firms" that search for lost securityholders. Examinations observed that:

- *Revenue-sharing.* Some transfer agents received a part of the fee that the search firms charged to securityholders when the securityholder was found on the third search. This fee-sharing could pose a conflict of interest, as it may conflict with the obligation of the transfer agent to use reasonable care to ascertain the securityholder's address during the first two required searches, as the transfer agent will stand to generate funds only if the securityholder is located during the third search. Some transfer agents received preferential pricing from the search firm for conducting the required two searches if they were also engaged to conduct the third search.
- *Reasonable care.* It appeared that some transfer agents inappropriately refused to deal with securityholders who attempted to correct their addresses on the transfer agents' records.

Charges to securityholder. Search firms retained by a transfer agent charged securityholders fees during the "free search" phase.

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

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

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

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Disclosures and Filings and Books and Records

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

1. *Information Disclosures, Reporting, and Filings*

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

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

2. *Books and Records*

- **Advisory, sub-advisory, administration, distribution, and custodial agreements entered into by the firm.**
  - ✓ Determine whether payments are made in accordance with the terms of all agreements.
  - ✓ Review contracts for both required and prohibited provisions.
- **Documentation of annual offer of Form ADV Part II.**
  - ✓ Determine whether Form ADV is offered or delivered annually.
  - ✓ Ensure that the firm maintains a copy of each statement given or sent to any client and a record of each offering.
- **Memorandum of each order given by the firm for the purchase or sale of any security.**
  - ✓ Ensure that the firm maintains order memoranda and determine whether the order memoranda contain all required information.
- **Access persons' initial and current annual holdings reports and quarterly transaction reports.**
  - ✓ Review reports to determine whether they contain all required information.
  - ✓ Determine what reviews, if any, the firm conducts based on the information contained in the reports.

B. Common Deficiencies

1. *Information Disclosures, Reporting, and Filings*

- **Inaccurate or incomplete disclosures**

  Examples:

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

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

- **Delivery of disclosures to clients**

  Examples:

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

- **Timeliness of filings**

  Example:

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

2. *Books and Records*

- **Completeness**

  Example:

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

- **Accuracy**

  Examples:

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

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

- **Accessibility**

  Examples:

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

- **Maintenance**

  Examples:

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

- **Safety**

  Examples:

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

C. Controls to Consider

1. *Information Disclosures, Reporting, and Filings*

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

2. *Books and Records*

   - Periodically sample performance records and order memoranda to ensure that they are maintained properly.

   - Periodically review all contracts to ensure that the terms are current and that fee schedules are accurate.

   - Periodically test the disaster recovery plan.

Portfolio Management

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

- **Firm's trading blotter or purchase and sales journal, including the transactions of the firm's access persons and proprietary accounts.**

  - ✓ Review trading activity to determine whether investments are in line with client objectives.

  - ✓ Determine if block trades were allocated using average price and consistent commission rates within the block.

  - ✓ Determine whether any principal and/or cross trades have been conducted. Verify that appropriate disclosures have been given and client consent obtained. Verify prices at which such trades were conducted and commissions charged. Cross trades could also be conducted in an effort to "dump" securities on certain clients to benefit other clients.

  - ✓ Review end of quarter/end of year trading for any evidence of "window dressing."

  - ✓ Calculate portfolio turnover for a sample of client accounts. Compare the turnover to the stated investment objective to look for disparities.

  - ✓ Review proprietary and access person accounts for possible frontrunning and/or personal securities policies and procedures violations as well as execution prices and commission rates that are more favorable than those for client accounts.

- **Performance returns for each client account for a specified period.**

  - ✓ Compare performance among accounts and composites to look for performance disparities for indications of favoritism or inequitable allocations.

  - ✓ Compare performance of personal, related, or proprietary accounts versus the performance achieved by clients for indications of favoritism toward insiders.

  - ✓ Calculate and compare the percentage of profitable trades in client accounts and personal, related, or proprietary accounts.

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

B. Common Deficiencies

- **Misleading or incomplete disclosures**

  Examples:

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

- **Inadequate policies and procedures**

  Examples:

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

C. Controls to Consider

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

Performance Advertising and Marketing

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

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

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

B. Common Deficiencies

- **Omitted or misleading disclosures**

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

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

- **Inappropriate advertising of past specific recommendations**

  Examples:

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

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

  Examples:

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

- **Inadequate policies and procedures**

  Examples:

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

C. Controls to Consider

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

Brokerage Arrangements and Execution, Trade Allocation, and Soft Dollars

A. <u>Documents and Information Examiners Frequently Request and Analyses Frequently Performed</u>

1. *Brokerage Arrangements and Execution*

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

2. *Trade Allocations*

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

3. *Soft Dollars*

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

- **Indicate whether the products or services received by advisers to registered investment companies pursuant to soft dollar arrangements are within the safe harbor provided in Section 28(e) of the Securities Exchange Act of 1934.** (Note: Advisers to registered investment companies may violate Section 17(e) of the Investment Company Act of 1940 if they receive products or services pursuant to soft dollar arrangements outside the safe harbor provisions of Section 28(e).)

  - ✓ If commissions are used to pay for non-research items (i.e., products and services that fall outside the safe harbor), determine whether this is adequately disclosed.

  - ✓ Determine whether any violations of Section 17(e) of the Company Act occurred.

- **Allocation procedures for mixed-use items.**

  - ✓ If a product or service is deemed of mixed-use, determine the appropriateness of the allocation between hard and soft dollars.

- **Provide the approximate annual amount of commissions on securities transactions needed to satisfy each soft dollar arrangement.**

  - ✓ Review the firm's periodic and systematic evaluations of brokerage firms used. Determine whether soft dollar brokers are deemed to provide good execution.

  - ✓ Ascertain whether the firm appears to be forgoing best execution in order to satisfy its soft dollar commitments.

  - ✓ Compare the current level of brokerage sent to the soft dollar brokers to the amount needed to satisfy the commitment.

B. Common Deficiencies

1. *Brokerage Arrangements and Execution*

- **Inaccurate disclosures**

  Examples:

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

  - ➢ Firms' trading practices were inconsistent with disclosures to clients.

  - ➢ Firms accepted client directed brokerage accounts without disclosing the effect on their ability to attain best execution for such clients.

  - ➢ Firms directed trades to affiliated broker-dealers and did not disclose such practices to clients.

  - ➢ Firms directed cross trades between advisory clients without disclosing such practices to clients.

- **Inadequate policies and procedures**

  Examples:

  - ➢ Firms did not have adequate policies and procedures governing their brokerage arrangements and execution.

  - ➢ Firms did not periodically and systematically review execution.

  - ➢ Firms did not document their evaluation to substantiate that they acted in a manner consistent with their fiduciary duty to clients.

- **Compensation for sale of fund shares**

  Example:

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

2. *Trade Allocations*

- **Inadequate policies and procedures**

  Examples:

  - ➢ Firms lacked sufficient policies and procedures to adequately address their trade allocation practices.

  - ➢ Firms did not implement adequate monitoring and testing procedures to ensure that trade allocations were fair and did not favor or discriminate against any client or account.

  - ➢ Firms did not follow their allocation policies and procedures consistently and frequently departed from their initial allocation decisions for inappropriate reasons.

  - ➢ Firms did not document their allocation decisions and reviews.

- **Inappropriate trade allocations**

  Examples:

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

3. *Soft Dollars*

- **Insufficient internal controls**

  Examples:

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

- **Inappropriate use of soft dollars**

  Examples:

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

C. Controls to Consider

1. *Brokerage Arrangements and Execution*

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

2. *Trade Allocations*

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

3. *Soft Dollars*

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

[Examiner requesting information]
[Regulatory agency]

Re: [Regulatory agency]'s Request for Attorney-Client Privileged and Confidential Materials

Subject to Supervisory Privilege – Confidential Treatment Requested

Dear [examiner]:

Pursuant to your request, please find enclosed following documents (collectively, the "Documents"):

[list documents]

The Documents reflect the results of reviews and analyses of certain operations of Capital One Financial Corp. or its subsidiaries (referred to collectively as "Capital One") that were performed at the direction and under the control of counsel for Capital One in furtherance of providing legal advice. The Documents are provided to the [regulatory agency] pursuant to its express request for such information and in the course of the regulatory and supervisory process.

As provided in 12 U.S.C. sec. 1828(x), neither the production of the Documents nor any discussion of their contents shall constitute a waiver of any privilege applicable to the Documents. Capital One requests that the information provided herein be accorded confidential treatment under the Freedom of Information Act and that this information not be disclosed to any third party, except to the extent that the [regulatory agency] determines that disclosure is required by law or is in furtherance of the agency's duties and responsibilities. Finally, Capital One requests that the [regulatory agency] return the Documents and all copies thereof to Capital One upon the conclusion of its review.

Should you have any questions relating to these documents or the information contained therein, please feel free to contact me at (703) 720-2235.

Very truly yours,

F. Thomas Eck, IV
Assistant General Counsel

EXAMINATION INFORMATION FOR BROKER-DEALERS, TRANSFER AGENTS, CLEARING AGENCIES, INVESTMENT ADVISERS, AND INVESTMENT COMPANIES

This brochure, prepared by the staff of the Securities and Exchange Commission (SEC or Commission), provides information about examinations conducted by the SEC examination staff, including the examination process and the methods employed by the staff for resolving problems found during examinations. This information, provided to firms under examination, should help you to better understand the Commission's objectives in this area.

I. PURPOSE OF EXAMINATIONS

The Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940 authorize the SEC to conduct examinations of firms that are registered with the SEC, including registered broker-dealers, transfer agents, clearing agencies, investment advisers, and investment companies. These statutes also authorize the SEC, by rule, to require registered firms to maintain certain books and records. The purpose of SEC examinations is to protect investors. Thus, during examinations, the SEC staff will seek to determine whether the firm is: conducting its activities in accordance with the federal securities laws and rules adopted under these laws (including, where applicable, the rules of self-regulatory organizations subject to the SEC's oversight); adhering to the disclosures it has made to investors; and implementing supervisory systems and/or compliance policies and procedures that are reasonably designed to ensure that the firm's operations are in compliance with the law. The SEC staff appreciates your cooperation with the examination process.

II. THE EXAMINATION PROCESS

Examinations are conducted by professional examination staff from the SEC's 11 regional offices, and its headquarters office in Washington, DC. The Office of Compliance Inspections and Examinations, located in Washington, DC, is responsible for the SEC's overall examination program.

Firms may be selected for examination for any number of reasons, including for a routine examination, because of an investor complaint, or in connection with a review of a particular compliance risk area. The reason why firms have been selected for examination is non-public information, and typically will not be shared with the firm under examination.

Examinations may be conducted on an announced or unannounced basis. When the examination is announced, the staff will send the firm a letter notifying it of the examination and containing a request list that identifies certain information or documents that SEC examiners will review as part of the examination. In some instances, the examiners may request that certain of the

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information and documents be provided in an electronic format. The request list may ask that the information and documents: (1) be delivered to the SEC's offices by a specified date; (2) be made available for review at the firm's offices on a specified date; or (3) some combination of the two.

Please communicate promptly with the examiners if you have any questions about the documents and information requested. In all cases, producing requested information and documents in a timely manner will facilitate the efficient completion of the examination.

As part of our pre-examination planning process, we actively work to ensure that our regulatory efforts are not duplicative. If you have any concerns in this regard, please contact the examiners responsible for the examination.

The examiners will provide the firm with SEC Form 1661, "*Supplemental Information for Regulated Entities Directed to Supply Information Other Than Pursuant to a Commission Subpoena,"* which provides information concerning the possible uses of information provided to the SEC (this form can also be accessed at www.sec.gov/about/forms/sec1661.pdf.) Upon request, the examiners will also provide the name and telephone number of their supervisor.

In many examinations, the examiners will visit the firm to conduct examination work on-site. Upon arrival, the examiners will identify themselves and present their SEC identifications. The examiners may conduct an initial interview. During this initial interview, the examiners will ask a series of questions about the firm and the activities to be examined. This information assists examiners in understanding the firm and its operations, and often assists examiners in determining the scope of the examination. The examiners may also ask for a walk-through of the firm's offices to gain an overall understanding of the firm's organization, flow of work, and control environment. Some examinations may be completed through the examiners' review of records in the SEC's offices along with telephonic or other interviews, as needed.

If the examination is unannounced, as soon as the examiners arrive they will provide the firm with an information or document request list and conduct an initial interview. During the initial interview, the examiners will go over the information or document request list to ensure that you understand the information and documents requested.

Following this initial phase of the examination, the examiners will review the information and documents provided by the firm. During this review, the examiners may make supplemental requests for additional information and documents. They may also request meetings with firm employees to discuss the firm's operations and the information and documents provided. These meetings help the examiners gain a better understanding of the firm's activities and compliance processes. The examiners may also request relevant information and documents from third parties that, for example, perform work for, or in conjunction with, the firm or where the third party activity may have a material impact on the firm.

On the last day of the on-site visit, the examiners will typically conduct an "exit interview" during which they will discuss the status of the examination and any outstanding information and document requests and, if appropriate, the issues identified during the examination to that point.

During an exit interview, the firm will be given an opportunity to discuss any of the issues that the examiners found and provide additional relevant information, including with respect to any actions that the firm has taken or plans to take to address the issues.

The examiners will then return to the SEC offices. In many cases, the examiners will perform additional analyses of the information or data obtained during the examination. This may include contacting the firm to ask clarifying questions or to request additional information or documents. In formulating the findings of the examination, the examiners may consult with other staff within the SEC, including supervisory staff and staff in relevant offices and divisions, to ensure that the findings are consistent with Commission rules, regulations, and interpretations.

If work performed subsequent to completion of the on-site portion of the examination identifies issues in addition to those discussed during the exit interview conducted on the last day of the on-site visit, the examiners will contact the firm, usually by telephone, to discuss these additional findings. During this discussion, which may constitute a "final exit interview," the firm will be given an opportunity to discuss any of the issues that the examiners found and provide additional relevant information, including with respect to any actions that the firm has taken or plans to take to address the issues identified.

III. COMPLETING AN EXAMINATION

After the completion of the on-site portion of the examination, the examiners will normally complete the examination within 120 days. If the examiners are unable to complete their work within that time, on or about the 120th day they will contact the firm to discuss the status of the examination and the likely schedule for completing the examination and for providing a final exit interview.

When an examination has been completed, the firm will be sent a written notification. This notification will generally take one of two forms: (1) the examination staff may send the firm a letter indicating that the examination has concluded without findings (often referred to as a "*no-further action letter*"); or (2) the examination staff may send the firm a letter that describes the issues identified, asks the firm to undertake corrective action and to provide the staff with a written response outlining those actions, and possibly requests a conference at the SEC's office (often referred to as a "*deficiency letter*"). If serious problems are found, in addition to sending the firm a deficiency letter, the examination staff may refer the problems to the Commission's Division of Enforcement, or to a self-regulatory organization, state regulatory agency, or other regulator for possible action. Notwithstanding the above, on occasion (usually in the context of certain exigent circumstances) problems may be referred to the Division of Enforcement without an exit interview or a deficiency letter.

As described above, a written notification that the examination has concluded will generally be sent to the firm no later than 120 days following the end of the fieldwork phase of the examination. The firm will be asked to respond in writing to any issues identified in a deficiency letter, including any steps that it has taken or will take to address the problems and to ensure that they do not reoccur. This response will generally be due within 30 days of the date of the deficiency letter.

Providing a timely and complete response to a deficiency letter will facilitate the examination staff's review of your response. In particular, please be sure to address all of the issues identified by the examiners. If the examiners have comments on your response, they will generally either provide them to you within 60 days, or contact you toward the end of that period to discuss their schedule for providing them to you. If the examiners have no further comments after receiving your response to a deficiency letter, they will send no further communication and the examination will be closed.

* * *

If you have any questions, comments, complaints, or concerns during an examination or after it is completed, please raise them with the examiners or with the examiners' supervisors in the respective regional office or headquarters office. Most questions and issues can be resolved by discussing them with members of the examination team. You may also communicate comments, complaints, or concerns through the *Examination Hotline*, (202) 551-EXAM. The *Examination Hotline* offers you a choice to speak with either a senior-level attorney in the Office of Compliance Inspections and Examinations in Washington, DC, *or* a staff member in the SEC's Office of Inspector General. The Office of Inspector General is an independent office within the SEC that conducts audits of Commission programs and investigates allegations of employee misconduct. When you speak with staff on the *Examination Hotline*, you may identify yourself or request anonymity.

SAMPLE SEC INVESTMENT ADVISER EXAMINATION DOCUMENT REQUEST LIST

<CONTACT PERSON>
Chief Compliance Officer
<ADVISER NAME>
<ADVISER STREET ADDRESS>
<ADVISER CITY, STATE, AND ZIP CODE>

Re: Examination of <ADVISER NAME> (the "Adviser")

Dear <CONTACT PERSON>:

The staff of the U.S Securities and Exchange Commission is conducting an examination of the Adviser pursuant to Section 204 of the Investment Advisers Act of 1940 (the "Advisers Act"). The purpose of the examination is to assess the Adviser's compliance with provisions of the Advisers Act and the rules there under.

Additional information about compliance examinations and the examination process is included in the enclosed "Examination Information" brochure (SEC Form 2489). Also enclosed is information regarding the Commission's authority to obtain the information requested and additional information: "Supplemental Information for Regulated Entities Directed to Supply Information Other Than Pursuant to a Commission Subpoena" (SEC Form 1661).

Information is Requested

Please provide all of the information specified in the enclosed information request list. Some of the information is to be provided to the staff by mail in advance of the staff's on-site examination, and the remainder of the items should be provided to the staff on the first day of the on-site examination. The staff requests that certain items be provided in an electronic format to the extent possible. Additional information about the desired electronic format is included in the document request list.

If the Adviser becomes aware of the need for delay in the production of any requested information that extends beyond the first day of the on-site examination, the Adviser should immediately contact the undersigned at the telephone number indicated. During the examination, the staff may also request additional or follow-up information, and will discuss timeframes for the Adviser to produce this information.

The On-Site Phase of Examination

The on-site phase of the examination will begin on <EXAMINATION START DATE>. The staff appreciated the Adviser's cooperation in facilitating the examination process.

We request that you make adequate office facilities available to the staff during the on-site examination, to ensure the confidentiality and efficiency of the examination. After arriving on-site, the staff would like to speak with at least one member of senior management to obtain an overall view of the Adviser's organization, business, compliance program, and compliance culture. Early in the on-site portion of the examination, the staff would also like to discuss the

Advisers overall compliance program as well as specific policies and procedures with the Adviser's Chief Compliance Officer. Also during the on-site portion of the examination, in order to understand fully the Adviser's operations and compliance controls in these areas, the staff will want to interview persons responsible for functions such as risk management, portfolio management, trade execution, research, back office/administration, information technology, anti-money laundering and marketing.

Background Regarding the Information Requested

Each investment adviser and investment company that is registered with the Commission is required to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws, and to review those policies and procedures annually for their continued adequacy and the effectiveness of their implementation. In addition, registered advisers and funds are required to designate a chief compliance officer responsible for administering the policies and procedures. Each adviser should adopt policies and procedures that take into consideration the nature of that firm's operations. The policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred.

The initial phase of a routine examination generally includes a review of the firm's business and investment activities and its corresponding compliance policies and procedures. The examination staff will request information and documents and speak with the firm's employees to ensure an understanding of the firm's business and investment activities and the operation of its compliance program. Using the information obtained, the staff will assess whether the firms' policies and procedures appear to effectively address the firm's compliance risks. The initial phase of a routine examination also includes testing the firm's compliance program in particular areas. The information requested and the purpose for requesting the information is described below.

- Certain general information is requested, such as the firm's organizational charts, demographic and other data for advisory clients and a record of all trades placed for its clients (trade blotter) – to provide an understanding of the firm's business and its investment activities.

- Information about the firm's compliance risks is requested, and the written policies and procedures that the firm has established and implemented to address those risks – to provide an understanding of the firm's compliance risks and its corresponding controls. This information would include, for example, any inventory performed of the firm's compliance risks and it compliance manual or policies and procedures.

- Documents relating to the firm's compliance testing is requested – to provide an understanding of steps taken by the firm to address the results of any compliance reviews, quality control analyses, surveillance, and/or forensic or transactional tests performed by the firm. This information would include any warnings to or disciplinary action of employees, changes in policies or procedures, redress to affected clients or other measures.

SAMPLE SEC INVESTMENT ADVISER EXAMINATION DOCUMENT REQUEST LIST

- Other information is requested – to allow the staff to perform testing for compliance in various areas.

As part of the pre-examination planning process, the staff actively coordinates examination oversight to ensure that regulatory efforts are not duplicative. If you have any concerns in this regard, please contact the undersigned.

Your cooperation is greatly appreciated in the examination process. If you have any questions, please contact <SEC CONTACT NAME>, Branch Chief at <LOCAL SEC OFFICE NUMBER>.

Sincerely,

<SEC ARD NAME>
Assistant Regional Director

Enclosures:
Information Request List
Examination Information Brochure (Form 2389)
Supplemental Information (Form 1661)
Exhibit 1: Layout for Securities Trading Blotter/Purchase and Sales Journal

Examination Information Request List

Examination Period

Information is requested for the period <START DATE> through <END DATE> (the "Examination Period").

Organizing the Information to be Provided

In order to efficiently process the material assembled for the staff's review, please group the information so that it corresponds to the item number in the request list. If information provided is responsive to more than one request item, you may provide it only once and refer to it when responding to the other request item numbers. If any request item does not apply to your business, please indicate "N/A" (not applicable).

Information to be Provided

I. **General Information**

A. Adviser's organization chart showing ownership percentages of the Adviser and control persons and a schedule or chart of all affiliated entities.

B. Names of any of the Adviser's officers and/or directors who resigned during the Examination Period and information regarding the reason for their departure.

C. Names of employees who were disciplined and/or terminated during the Examination Period and information regarding the reason for the action.

D. Any threatened, pending and settled litigation or arbitration involving the Adviser or any "supervised person" (if it related to the individual's association with the adviser or a securities-related matter) including a description of the allegations, the status, and a brief description of any "out of court" or informal settlement. Note that the "supervised person" is any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser an is subject to the supervision and control of the investment adviser (defined in Section 202(a)(25) of the Adviser's Act). If none, please provide a written statement to that effect.

E. Current standard client advisory contacts or agreements.

F. All sub-advisory agreements executed with other investment advisers.

G. Current fee Schedules(s), if not otherwise stated in advisory contracts or in Form ADV Part II.

H. Any power attorney obtained from clients, if not otherwise stated in advisory contracts.

SAMPLE SEC INVESTMENT ADVISER EXAMINATION DOCUMENT REQUEST LIST

I. Names of any joint ventures or any other businesses in which the Adviser or any officer, director, portfolio manger, or trader participates or has any interest (other than their employment with the Adviser), including a description of each relationship.

J. The Form ADV Part II furnished to clients during the Examination Period and any disclosure document used in conjunction with or in lieu of Part II.

K. The names and location of all service providers and the services they perform and, for both affiliated and unaffiliated providers, information about the due diligence process to initially evaluate and monitor thereafter the work provided and how potential conflicts and information flow issues are addressed.

II. **Information Regarding the Adviser's Compliance Program, Risk Management and Internal Controls**

The Staff requests the information listed below to assist in evaluating the Adviser's compliance program. If the Adviser does not have information that is responsive, please state "none."

A. Compliance Policies and Procedures and Testing

1. All compliance policies and procedures that were in effect during the Examination Period.

2. Information relating to the firm's compliance testing, including any compliance reviews, quality control analyses, surveillance, and/or forensic or transactional test performed by the firm. This information should include any significant findings, both positive and negative, of such testing and any information about corrective or remedial actions taken regarding these findings. Staff will review these documents on-site.

B. On-going Risk Identification and Assessment

1. A current inventory of the Adviser's compliance risks that forms the basis for its policies and procedures, including any changes made to the inventory and the dates of the changes.

2. Any documents maintained that map the Adviser's inventory of risks to its written policies and procedures.

3. Any written guidance that Adviser has provided to its employees regarding its compliance risk assessment process and the process for creating policies and procedures to mitigate and manage it compliance risks

C. Use of Internal Audit

Any internal audit review schedules and completed audits including the subject and the date of the report.

D. Supervision of Remote Offices and/or Independent Advisory Contractors

Information about the oversight process the Adviser uses for any remote offices and/or independent advisory contractors, and any policies and procedures with respect to such oversight.

E. Client Correspondence and/or Complaints

Any client or investor complaints, and information about the process used for monitoring client correspondence and/or complaints, including the name of any third-party service provider used and the Adviser's oversight of the service provider.

F. Annual and/or Interim Reviews

Documentation maintained regarding any reviews conducted of the Adviser's policies and procedures, including any annual and/or interim reports.

G. Compliance Issues Log

A record of non-compliance with the Adviser's Code of Ethics and of any action taken as a result of such non-compliance.

H. Valuation

1. Names of all pricing services, quotation services and externally-acquired portfolio accounting systems used in the valuation process and information about whether they are paid in hard or soft-dollars, or a combination.

2. Names of all fair-valued and illiquid securities held by clients, and a description of any fair value process employed including any testing and results and all fair value reports prepared or reviewed by a valuation committee

3. Supporting documentation for the most recent advisory fee calculation, including performance fees and the manner in which the fees were calculated

I. Information Processing, Reporting and Protection

1. Documentation of controls of employee access (i.e., electronic key card entry, locks, security cameras, and guards) to physical locations containing customer information (i.e., buildings, computer facilities, and records storage facilities).

2. Documentation of electronic access controls, including user authorization and authentication, firewall configuration, security advisories on vulnerabilities in software and hardware installation configurations, and implementing work-arounds, security patches and upgrades.

3. The Adviser's business continuity plan

III. Information to Facilitate Testing with Respect to Advisory Trading Activities

The information described below is requested in order to facilitate testing of compliance with respect to advisory trading activities.

A. A trade blotter (i.e., purchases and sales journal) that lists transactions (including all trade errors, cancellations, re-bills, and reallocations) in securities and other financial instruments (including privately offered funds) for: current and former clients; proprietary and/or trading accounts and access persons. The preferred format for this information is to provide it in Excel as indicated in Exhibit 1.

B. Provide the information below for all advisory clients. The preferred format for this information is in Excel.

1. Current advisory clients, indicating those that are warp clients, including:

a. The Account number, name and current balance, as of <END DATE>;

b. whether the client is a related person, affiliated person, or a proprietary account;

c. the type of account (e.g., individual, defined benefit retirement plan, registered fund, or unregistered fund);

d. the account custodian and location;

e. whether or not the custodian sends periodic account statements directly to the client; whether or not the delivery is electronic, if so, a copy of the authorization; and the form of electronic delivery (e.g., email or website login);

f. whether or not the Adviser has discretionary authority;

g. whether the Adviser, an officer, or an affiliate acts as trustee, co-trustee, or successor trustee or has full power of attorney for the account;

h. whether the Adviser or related persons are deemed to have custody of, possession of or access to the client's assets, and if so, the location of the assets;

i. the investment strategy (e.g., global equity, high-yield aggressive growth, long-short, or statistical arbitrage) and the performance composite in which it is included, if any;

j. the Account portfolio manager(s);

k. whether the client has a directed brokerage arrangement, including commission recapture (provide the name of broker(s), details of the arrangement and any reports used to monitor payments of commissions);

l. the value of each client's account that was used for purposes of calculating its advisory fee for the most recent billing period;

m. whether the client pays a performance fee and the most recent account performance figures;

n. whether or not advisory fees are paid directly from the client's custodial account; and

o. for clients obtained during the Examination Period, provide account inception date and name(s) of consultant(s) related to obtaining the client, if any.

2. Names of advisory clients lost, including the reason, termination date and asset value at termination.

3. Names of any financial planning, pension consulting or other advisory clients not named in response to Item 1 above.

C. Portfolio Management

1. Names of securities held in all client portfolios (aggregate position totals for all instruments) as of <END DATE>. This record should include the security name, name of each client holding an interest, the amount owned by each client, the aggregate number of shares or principal and/or notional amount held and total market value of the position. The preferred format for this information is in Excel.

2. Minutes of investment and/or portfolio management committee meetings, if such committees exists, and minutes are maintained.

3. Names of any publicly traded companies for which employees of the Adviser or its affiliates serve as officers and/or directors, and the name(s) of such employees.

4. Names of companies for which employees or the Adviser or its affiliates serve on creditors' committees, and the name(s) of such employees.

SAMPLE SEC INVESTMENT ADVISER EXAMINATION DOCUMENT REQUEST LIST

5. The Adviser's ten most profitable and ten least profitable (including unrealized gain or loss) investment decisions based on total return of positions opened and closed for each investment strategy or mandate offered to clients. Please include the purchase date, sale date, percentage of gain and/or loss, and dollar amount of the gain and/or loss.

D. Brokerage Arrangements

1. Any documents created in the evaluation of brokerage arrangements and best execution.

2. Soft dollar budget or similar document that describes the products and services the Adviser obtains using clients' brokerage commissions.

3. Commission-sharing arrangements including the name of the broker-dealer and total dollars allocated to each arrangement during the Examination Period.

4. All affiliated broker-dealers including a description of the affiliation and of their clearing arrangements.

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

E. Trade Allocations

All initial public offerings and secondary offerings in which clients, proprietary accounts or access persons participated and, if not stated in policies and procedures or if the allocation did not follow standard policies and procedures, information regarding how allocation decisions were made. Include the trade date, security, symbol, total number of shares, and participating accounts. For initial public offerings, indicate whether shares traded at a premium when secondary market trading began. The preferred format for this information is in Excel.

F. Conflicts of Interest and/or Insider Trading

1. The Adviser's and affiliates' Code of Ethics and insider trading policies and procedures.

2. If not incorporated in the Code of Ethics, any policies and procedures adopted to address exemptions for employees, including those for personal hardship, if applicable.

3. If not incorporated in the Code of Ethics, any policies and procedures governing personal trading of contract employees and temporary employees, if applicable.

4. If not stated in policies and procedures, any guides for monitoring personal trading of access persons.

5. Reports of' securities transactions reported by access persons.

6. If not stated in policies and procedures, information about the process used to monitor and control the receipt, flow and use of non-public information, including any restricted, watch or grey lists.

7. Any fee splitting or revenue sharing arrangements.

IV. Performance Advertising and/or Marketing

The information described below is requested in order to facilitate testing of compliance with respect to advertising, marketing and performance claims.

A. All pitch books, one-on-one presentations, pamphlets, brochures, and any other promotional and/or marketing materials furnished to existing and/or prospective clients for each investment strategy and/or mandate.

B. All advertisements used to inform or solicit clients. If information on services and investments is available on the Internet, such as websites and blogs, make all versions available as either printouts or electronic archives.

C. If websites include sections for clients or advisory representatives that are accessible only with a username and password, please establish a temporary username and password for the staff's use during the inspection and include them in your responses.

D. All performance return composites including: description and investment objective, inception date, inclusion criteria, e.g., account minimum, and whether or not it is used in marketing.

E. All accounts included in each composite as of <END DATE>. Also, the staff may request the following records for each client account in an advertised performance composite:

1. Internal calculations indicating beginning and ending asset values for each quarter, all capital additions and withdrawals (including the dates) and the quarterly performance return.

2. All custodial statements, including a statement that indicates the beginning asset value for the performance period. For example, the December 2006 statement for the verification of the calendar year 2007 performance returns.

F. All accounts not included in a composite.

G. All terminated composites.

H. All parties compensated for soliciting clients or investors to affiliated private investment vehicles including: total cash and non-cash compensation paid and a summary of the

SAMPLE SEC INVESTMENT ADVISER EXAMINATION DOCUMENT REQUEST LIST

business relationship with that entity (e.g., consulting, prime brokerage, securities lending, etc.).

I. All agreements, correspondence and the separate disclosure documents for third-party solicitors.

J. All requests for proposals ("RFP's") completed.

K. Names of all third-party consultants that the Adviser provided responses to questionnaires.

L. Documentation that the Adviser is complying with the Global Investment Performance Standards (GIPS"), if applicable.

V. Financial Records

A. Adviser's balance sheet, trial balance, income statement and cash flow statements as of the end of its most recent fiscal year and the most current year to date.

B. Adviser's cash receipts and disbursements journal.

C. Adviser's general ledger and chart of accounts.

D. Any loans from clients to the Adviser or sales of the Adviser's or any affiliate(s) stock to clients.

SUPPLEMENTAL INITIAL REQUEST ITEMS

Advisers Sponsoring or Managing Privately Offered Funds

VI. Unregistered Funds

A. Information regarding each private investment fund, including:

1. Name as shown in organizational documents (as amended).

2. Domicile (country).

3. Investment strategy (e.g., long-short, statistical arbitrage, fund of funds).

4. If funds are part of a master/feeder fund structure, full name and domicile of each fund.

5. Number of investors and total assets as of <END DATE>.

6. Amount, if any, of Adviser's equity interest in each fund as of <END DATE>.

7. Amount, if any, of Adviser's affiliated persons' interest as of <END DATE>.

8. Date the fund begin accepting unaffiliated investors.

9. Whether the fund is currently closed to new investors.

10. Lock-up periods for both initial and subsequent investments.

11. Specific exemption(s) from registration under the Securities Act of 1933 and/or the Investment Company Act of 1940 upon which each fund relies.

12. Services the Adviser or an affiliate (e.g., general partner, adviser, managing member) is providing.

13. Amount of leverage, both explicit (on-balance sheet) and off-balance sheet (futures and certain other derivatives), used by the fund as of <END DATE> as measured by the Adviser for risk management purposes.

B. For each private fund please provide the following:

1. Organization document and operating agreement (e.g., partnership agreement).

2. Financials, audited or un-audited, for its two most recent fiscal year ends.

3. General ledger, separated by calendar year, underlying the above-referenced statements.

4. Organizational chart of the general partner/managing member.

5. Account statements sent to investors during the current fiscal year, if any.

6. Names of current investors including total current value of each investor's equity interest in the fund.

7. Names of investors who purchased and redeemed an interest in the fund during the Examination Period.

8. Latest advisory fee calculation, including any performance fee calculations, and the specific manner in which the fees were calculated.

9. A complete description of all positions held in side pockets or special situation accounts together with their valuation on the date of the related calculation of net asset values.

10. Provide fund custodial statements for the Examination Period.

SAMPLE SEC INVESTMENT ADVISER EXAMINATION DOCUMENT REQUEST LIST

11. Side agreements/arrangements in which investors are participants. Please provide a description for each agreement/ arrangement.

C. If an entity, other than the fund's Adviser, maintains records regarding the interests of each fund investor in the fund, please request that entity to provide a confirmation of the following, as of <END DATE>:

1. Total number of shares outstanding if fund is in corporate form.

2. Total number of limited partners.

3. Most recently calculated value of each limited partner's interest in the fund.

VII. Advisers with Clients That Invest in PIPEs

A. Information regarding compliance breaches involving PIPEs that occurred during the Examination Period, if applicable. Include details about the resolution.

B. Names of sub-advisers selected and recommended by the Adviser.

SAMPLE SEC INVESTMENT ADVISER EXAMINATION DOCUMENT REQUEST LIST

Exhibit 1

Layout For Securities Trading Blotter/Purchase and Sales Journal

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

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

Examples:

I. Sample Trading Blotter for Equity Securities

Client Name/#	Trade Date	Settle Date	Buy/ Sell	CUSIP	Security Symbol	Security Description	Quantity	Unit Price	Principal/ Proceeds/ Notional Value	Total Commission	Fees	Net Proceeds	Broker
155	1/1/00	1/3/00	B	1234567	MSFT	Microsoft Corp.	100	$100.00	$10,000	$10.00		$9,900	ABC
123	1/2/00	1/5/00	S	89101112	IBM	IBM Corp.	500	$100.00	$50,000	$50.00	$1.67	$49,948.33	DEF

II. Sample Trading Blotter for Fixed Income Securities

Client Name/#	Trade Date	Settle Date	Buy/ Sell	CUSIP	Security Description 1 (Issuer)	Security Description 2 (Coupon, Maturity, etc.)	Quantity	Unit Price	Accrued Interest	Principal Value/ Proceeds	Total Commission	Net Proceeds	Broker
155	4/2/98	4/6/98	B	802586AG2	Santa Rosa CA Pkg Facs Dist	4.60% 07-02-2004	50,000	100	$95.83	$50,000	$0	$50,095.83	GHI

Ten Things to Consider

1. Appoint a central point person (manager) to coordinate examination.
2. Coordinate with all pertinent areas within institution to include third party vendors, outside auditors and consultants, document archives and senior management.
3. Understand examination scope, time period covered, and information request for records and documentation.
4. Hold orientation meeting for examination team.
5. Develop schedule for examiner briefings and meetings with key managers. Have the right people in the room to brief the examiners, answer questions and available for follow-up discussions.
6. Establish and maintain clear communications with examiner in charge. Monitor examination progress through regular, ongoing contact with examination team to check on adequacy of information provided, confirm availability of management and documentation, and resolve open questions and issues to the extent possible. Provide accurate and complete information.
7. Encourage senior management and compliance and audit functions to prepare and deliver a presentation on strengths and weaknesses or control gaps in the infrastructure.
8. Develop an action plan to address identified weaknesses or control gaps prior to commencement of examination. Present remediation plan to examination team.
9. Review status of prior examination issues to determine what has been fully addressed and whether an independent party such as internal audit has validated the corrective action. Determine what is still a work in progress and why. Prepare an action plan and be ready to discuss current status of open items.
10. Prepare for pre-close out and final close-out meetings. Identify opportunity to provide additional information in response to findings, if possible. Know what you are facing and keep senior management/BOD informed of examination status and possible issues or problems.

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 4th 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.

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