

SEC Exam Staff Issues Second ComplianceAlert

July 25, 2008

On July 22, the Securities and Exchange Commission's (SEC's) Office of Compliance, Inspections, and Examinations (OCIE) issued a ComplianceAlert, the second in a planned series of periodic updates that will summarize select areas of operational deficiency that SEC examiners have found during examinations of broker-dealers, investment advisers, investment companies, transfer agents, and other types of registered firms. Legal and compliance departments at such firms can use the ComplianceAlert to help identify those deficiencies that the SEC staff has noted in the past and that may need to be addressed. In addition, the ComplianceAlert suggests a number of practices that the OCIE found exemplary, which may merit implementation at other firms. Finally, from an enforcement perspective, the ComplianceAlert may be an indication of emerging compliance issues that the OCIE has chosen to address informally at this stage that may serve as the basis for enforcement referrals in the future.

A summary of some of the more notable aspects of the letter follows.

Investment Advisers/Mutual Funds

Personal Trading by Advisory Staff. The SEC staff conducted a risk-targeted examination that focused on advisers' compliance practices and internal controls relating to access persons' personal trading and trading in proprietary accounts. The SEC staff noted that many firms had codes of ethics with insufficient preclearance provisions and weak control procedures regarding oversight of investment personnel. The SEC staff also noted that some firms did not enforce the provisions in their firm's code of ethics pertaining to preclearance, trading prohibitions, and the submission and review of transaction and holding reports. The SEC staff therefore highlighted a number of effective internal compliance controls and compliance review and reporting mechanisms relating to personal trading.

Third-Party Proxy Voting Services. The SEC staff noted in its review of mutual fund use of third-party proxy voting services that board oversight of proxy service providers appeared to be weak in some instances, and that some advisers did not document their assessment of proxy service providers. While the SEC staff observed that most firms had adopted proxy voting policies and procedures, they also found that in certain instances the procedures were not followed, or contained inaccurate information.

Valuation and Liquidity Issues in High-Yield Municipal Bond Funds. The SEC staff examined high-yield bond funds and noted that high-yield funds with higher average credit qualities, fewer unrated securities, and fewer distressed and defaulted securities were generally less likely to have valuation and liquidity issues raised by examiners. The SEC staff commented when the percentage of illiquid securities held by a fund dramatically increased and the fund did not disclose the following:

- (1) That a dramatic increase in the percentage of the fund invested in illiquid securities occurred and the risks associated with such an increase
- (2) 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

- (3) What steps, if any, the fund may take to dispose of some of the illiquid securities to bring the percentage within the range appropriate to the circumstances.

The SEC staff also noted that a fund registration statement disclosure that represents that its pricing source provided “independent” values for securities held by high-yield funds may be misleading if the pricing services relied on fund management to value such securities. Examiners also noted instances in which funds did not assess the accuracy of prices provided by pricing services, and recommended the maintenance of electronic records to allow for more efficient analysis of fund records.

Soft Dollar Practices of Investment Advisers. The SEC staff recently reviewed the soft dollar arrangements of a number of registered investment advisers and noted that most firms received both proprietary and third-party products and services through soft dollar arrangements with broker-dealers and had informal commission “targets” with these broker-dealers. The SEC staff noted that most advisers documented their efforts to seek best execution as required and highlighted a number of practices that were particularly effective in this process.

Broker-Dealers

Examinations of Securities Firms Providing “Free Lunch” Sales Seminars. The Financial Industry Regulatory Authority (FINRA), the North American Securities Administrators Association (NASAA), and the SEC conducted a series of over 100 examinations of broker-dealers, investment advisers, and other financial services firms that offer “free lunch” sales seminars. The SEC staff noted in the course of these examinations that seniors, the target attendees of the seminars, were generally encouraged to attend through attractive inducements such as free meals, prizes, or vacations. In some cases, unsuitable recommendations to purchase investments were made at the sales seminars, or following the seminar when an attendee opened an account. SEC examiners found that the attendees did not always understand that the seminar was sponsored by an undisclosed company with a financial interest in product sales. In addition, the examiners found that some firms sponsoring these events did not submit their advertising materials for review by FINRA, and had misleading and/or exaggerated advertising and insufficient compliance and supervisory controls with respect to the seminars they conducted.

Valuation and Collateral Management Processes. SEC examiners coordinated with FINRA and recently completed examinations of select large broker-dealers to assess their valuation and collateral management practices as they relate to sub-prime mortgage-related products. The SEC staff noted that, due to the lack of market liquidity, many firms had difficulty in independently verifying their inventory valuations and consequently relied on modeled prices or more broadly observable market information available in derivative markets. The SEC staff also noted inconsistent pricing, price verification, and documentation policies and procedures, and observed insufficient staffing at some firms. The SEC staff also highlighted a number of effective control practices for valuation and collateral management.

Broker-Dealers Affiliated with Insurance Companies. SEC examiners conducted targeted reviews of a number of broker-dealer subsidiaries of insurance companies, and noted instances of unsuitable recommendations and supervisory procedures, as well as deficiencies in firms’ compliance with financial responsibility requirements. The examiners noted that in some cases the deficiencies occurred in firms managed by individuals whose primary experience was in the insurance industry rather than in the securities industry.

Supervision of Solicitations of Advisory Services. SEC examiners conducted a series of examinations of broker-dealers that had designated their registered representatives as “solicitors” for an investment adviser. At some firms, the SEC staff noted a lack of responsibility or supervision for suitability and a failure to file sales material with FINRA.

Mortgage Financing as Credit for the Purchase of Securities. The SEC staff conducted a risk-targeted examination of broker-dealers to evaluate the practice of broker-dealers recommending the purchase of securities financed through a second or reverse mortgage from an affiliated bank. The SEC staff commented upon the suitability of recommendations to mortgage a home in order to purchase securities and generally found that supervision and recordkeeping related to these activities appeared to be inadequate.

Office of Supervisory Jurisdiction (OSJ) Supervisory Structure. SEC examiners conducted a review of a sample of broker-dealers’ supervisory and compliance controls under an OSJ structure. The SEC staff found that many broker-dealers had not adopted, implemented, and/or consistently adhered to adequate written supervisory or recordkeeping procedures.

Transfer Agents

Transfer Agent Practices Relating to “Lost Securityholders.” When the address of a securityholder is lost, transfer agents are required to conduct two free searches to obtain the securityholder’s correct address. The SEC staff noted that some transfer agent firms did not adhere to this rule in order to obtain fees in connection with the search for the correct address information for security holders.

To view the ComplianceAlert, please visit: <http://www.sec.gov/about/offices/ocie/complialert0708.htm>.

Investment Management FYI is a service of the Broker-Dealer and Investment Management Practices of Morgan Lewis. If you have any questions concerning these important legal developments, please contact any of the following Morgan Lewis attorneys:

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