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Compliance Roundtable Seminar

PHILADELPHIA, PA SEPTEMBER 16, 2009

Investment Adviser Session

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The Changing of the Guard

The SEC They Are A-Changin'

- OCIE and Enforcement – "Turnover" at the Top
  - Washington, DC (HQ)
  - NYRO
- Staff training
- Additional resources
- Use of technology

SEC's Key Personnel Changes

In

- Rob Khuzami, Director of the SEC's Division of Enforcement (former federal prosecutor)
- Lorin L. Reisner, Deputy Director of the SEC's Division of Enforcement (former federal prosecutor)

Out

- Lori Richards, OCIE Director since its inception
- Tom Biolsi, Associate Regional Director for Examinations in NYRO

Enforcement Division Shakeup

- "*pulling from the Justice Department's playbook*"
- Several new initiatives:
  - Senior enforcement attorneys can now approve formal orders of investigation (subpoena power)
  - more frequently offering immunity and deferred prosecution for individuals cooperating with investigations
- Investigations – up 10%; formal orders – up 118%; TROs – up 147%; cases – up 30%.
- SEC Seal Teams - creation of 5 specialized enforcement units
  1. Asset-management companies, such as hedge funds and private-equity funds;
  2. Market abuse, including possible insider trading of securities around market announcements;
  3. Structured and new products, such as credit-default swaps;
  4. Alleged bribery of foreign officials; and
  5. Municipal securities and public pension funds

Source: *SEC to Give Attorneys More Power* , Wall Street Journal, August 6, 2009.

Aggressive SEC Enforcement

"If defense counsel resist the voluntary production of documents or witnesses, or fail to be complete and timely in responses or engage in dilatory tactics, there will very likely be a subpoena on your desk the next morning."

- Robert Khuzami, Director of the SEC's Enforcement Division

Source: *SEC plans more subpoena power, enforcement units* , Reuters, August 5, 2009.

New SEC Staff Training

- August 2009 - SEC, FINRA and NASAA sponsored a joint training program for our examiners. Presenters included:
  - experienced SEC, FINRA and state examiners and investigators
  - criminal investigators from the FBI
  - forensic auditors
  - convicted fraudster
- CFE – more than 1/3 of OCIE's inspectors have signed up to become "Certified Fraud Examiners"
- Dual registrants - new training for examiners to better conduct examinations of firms that are registered as both broker-dealers and investment advisers

Source: *Strengthening Examination Oversight: Changes to Regulatory Examinations* , SEC Speech by Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations, June 17, 2009.

SEC's Increasing Resources

- Additional $20 million in funding approved by U.S. Senate for FY 2010 = 60 new investigators
- Industry and Markets Fellows Program*
  - Staffed by industry experts to "infuse the agency with knowledge of complex industry practices and products"
  - Work in SEC's Office of Risk Assessment for 2 to 4 years
  - Annual salaries will range from $108,286 to $227,300
  - Broad areas of expertise, including: trading equity and fixed-income securities, structured products, complex derivatives, financial analysis and valuation, fund management, investment banking and financial service operations

*Source: *SEC Unveils Program to Woo Industry Experts*, Ignites.com, May 1, 2009.

Transparency and Data Flow to SEC

"To establish and maintain an effective surveillance program, the SEC would need to have a constant flow of timely and reliable information about each firm surveilled, as well as the technology and resources to monitor and analyze the data and information. This would enable SEC staff to gauge the relative compliance risk that each entity presents at a point in time and to monitor changes to these risk profiles over time...the SEC is seeking funding for additional investments in our information systems to mine data from examinations, investigations, filings, tips, and to link it together, and combine it with data sources from outside the SEC to help us determine which firms or practices raise red flags and deserve a closer look."

Source: *Strengthening Examination Oversight: Changes to Regulatory Examinations* , SEC Speech by Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations, June 17, 2009.

Recent SEC Examinations

Re-Energized SEC Staff

"A strong and reinvigorated SEC will be on the beat like never before to catch wrongdoers."

– Mary Schapiro, SEC Chairman

Source: *Practicing Law Institute's "SEC Speaks in 2009" Program*, Washington, DC, February 6, 2009.

A Tougher, No-Nonsense SEC?

"We really are now going to take a no-excuses approach to compliance with the law…firms really need to be ready to be examined by the SEC."

- Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations

Source: *Richards Talks Tough: SEC Examiners Will Take 'No Excuses'*, ACA Insight, February 16, 2009.

Production of Records: SEC Expectations

- OCIE working with the SEC's Division of Enforcement to create a policy about when examiners will refer a delay in production or lack of cooperation to SEC enforcement attorneys
- "*Examiners will be less tolerant of delays in the production of information and documents…I want examiners to have a clear sense of when they should refer matters to the Division of Enforcement staff when production of documents has not been timely and when we feel that firms have not been fully cooperative with examiners during the examination process.*"

– Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations

Source: *Richards Talks Tough: SEC Examiners Will Take 'No Excuses'*, ACA Insight, February 16, 2009.

Recent SEC Examination Developments

- Interesting developments related to SEC inspections that have commenced within the past few months:
  - Surprise examinations are back!
  - Email requests span up to 2 years with no "keyword" qualifiers
  - Requests for all versions of particular documents during a review period (e.g., Form ADV, II, Compliance Manual, advertisements)
  - Questions about compliance budgets and potential cost cutting initiatives
  - Previous deficiency letters. Re-open those letters and your firm's response and ensure that all issues have been properly remediated.

Custody and Safekeeping of Client Assets

Custody and Safekeeping of Client Assets

- Custody rule under Advisers Act
- Proposed rule – comments were due on July 28, 2009
- GAAP audit requirement and focus on private funds
  - Distributed within 120 days to all investors/shareholders (180 for fund-of-funds)
  - Unqualified opinion

Proposed Changes to Custody Rule

- Major proposed changes:
  - Surprise audit for any adviser with custody, even if only because of ability to deduct fees
  - Expanded reporting by accountants conducting surprise audit
  - If custodian is adviser or affiliate, accountant must be PCAOB-registered and internal control report required (SAS 70, Level II)
  - Advisers relying on exception with regard to funds subject to annual audit must have liquidation audit done

Custody Rule Comment Letters

- Commission received approximately 1,300 comment letters (400 of which were letter writing campaigns in seven basic formats)
- Comments addressed a wide variety of issues including, among others:
  - Direct debiting of advisory fees
  - Estimated costs of the surprise verification
  - Surprise verification vs. annual GAAP audit for private fund clients
  - Self-custody arrangements
  - CCO certification
  - Auditor independence

Direct Debiting of Fees

"There is absolutely no evidence that clients are being harmed by direct-fee deduction arrangements"

Mari-Anne Pisarri, Partner, Pickard and Djinis LLP

Surprise Audit Costs

"*NSCP believes the SEC should recognize that, even if this estimate is accurate, $8,000 in increased regulatory costs is significant for many small advisers. More importantly, we believe that the SEC's estimate is far too low, both as a general matter for advisers subject to the surprise audit obligation and as specifically applied to advisers who become subject to it because their fees are automatically deducted by a custodian. Our own members have received preliminary estimates from their independent auditors as high as $25,000 for each annual surprise audit. In the event that different clients of an adviser have assets custodied at more than one custodian, the costs of these annual surprise audits would be multiplied accordingly*" [Emphasis Added].

Comment Letter, National Society of Compliance Professionals, July 28, 2009

SEC Director on Custody Focus

"Examiners are going to be out in force looking at your controls over custody…Don't wait for us to do it. Do it now…We will want to tie the firm's records and the firm's account statements to customers back up to independent custodian … so we will be spending an enormous amount of time really confirming the existence of client and customer assets."

– Lori Richards, OCIE Director

Source: *Richards Talks Tough: SEC Examiners Will Take 'No Excuses'* and *SEC Sweeps on Custody*, ACA Insight, February 16, 2009.

SEC Focus on Auditor Relationships

- SEC examiners have asked advisers to sign an authorization requesting work papers from their Fund's auditor
- SEC staff requesting meetings/discussions with a fund's auditor with respect to various issues (e.g., clawbacks related to Madoff lawsuits)
- What due diligence did the adviser perform on the auditor for its funds? What documentation was maintained?
- Is the auditor registered with the PCAOB?
- Do the auditor or its personnel have any investments in the funds or with the adviser?
- Does the adviser or the auditor send audited financial statements and K-1s to investors?

Additional Custody Considerations

- SEC staff "down-the-chain" custody requests – contacting clients and investors to verify account balances (FoF – capital account balances, cash flows and all holdings of the fund)
- Liquidation audits – can a manager forgo a final audit due to expense considerations?
- "Due inquiry" requirement – what about clients that do not want to get "copies" of account statements (e.g., foreign clients)?
- Exception from qualified custodian requirement for certain privately offered securities – bank debt, trade claims and other investments subject to this provision?

Portfolio Mandate Compliance

SEC Focus on Portfolio Mandate Compliance

"Advisers simply cannot tell investors they are going to do one thing with their funds and then not follow through on those promises."

- Linda Chatman Thomsen, former Director of the SEC's Enforcement Division, July 30, 2008

Source: *SEC Charges Mutual Fund Manager for Violating Socially Responsible Investment Restrictions*, SEC Press Release No. 2008-157, July 30, 2008.

Recent Portfolio Mandate Case Studies

- In the Matter of Hennessee Group LLC and Charles J. Gradante, Advisers Act Release No. 2871, April 22, 2009
  - In the course of soliciting clients, Hennessee Group…made numerous representations concerning the quality and rigor of its due diligence process for evaluating hedge funds.
- New York Law School v. Ascot Partners, L.P., J. Ezra Merkin and BDO Seidman LLP, December 16, 2008.
  - "*…neither the Offering Memorandum nor any other offering material used in soliciting investment in Ascot ever disclosed that virtually all of Ascot's assets were invested with Madoff, BMIC or other Madoff controlled entities.*"
- In the Matter of Pax World Management Corp., Advisers Act Release No. 2761, July 30, 2008.
  - Sanctioned for not following stated social screens
  - Note: no harm alleged

It's More Than Just the IMA…

- Investment Management Agreement (IMA)
- Private Offering Memorandum (PPM)
- Flipbooks
- Due Diligence Questionnaires
- Responses to RFPs
- One-on-One Presentations
- Annual Client or Investor Meeting Materials
- Verbal Representations

Marketing, Advertising & Investor/Client Relations

Regulatory Focus on Advertising

- Are the materials accurate and truthful?
- Performance track records
- Composite construction
- Assets under management
- Pay-to-play and client/investor solicitation arrangements
- Selective disclosure
- Increasing use of social media (Facebook, LinkedIn, Twitter)

Marketing Materials

- Scrutiny of performance calculations
- Past specific recommendations – creation of unique pieces appear to be on the rise (TCW no-action letter)
- Composite construction – inclusion/removal of accounts that have placed restrictions on adviser within the past year
- Focus on assets under management (related to focus on custody)

Pay-to-Play

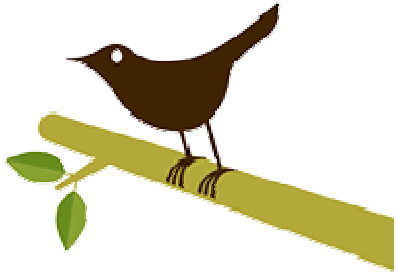
- New York AG (Cuomo) investigation
- SEC Investigations
- SEC Rule Proposal – Comments due by Oct. 6, 2009

Selective Disclosure

- Are those in pooled vehicles (private funds or mutual funds) treated equally with regard to the disclosure of important information about the fund?
- In the Matter of Evergreen Investment Management Company, LLC and Evergreen Investment Services, Inc., Advisers Act Release No. 2888, June 8, 2009.
  - "*talking points…intended to be shared with any Ultra Fund shareholder or registered representative who made an incoming call to any of the Evergreen Distributor's wholesalers to discuss the Fund's recent NAV decreases.*"
  - "Evergreen Adviser willfully violated Section 204A of the Advisers Act…Evergreen Adviser disclosed material, non-public information about the Ultra Fund to an affiliate…"

Electronic Communications

- Emails and instant messages
- Internet websites
- Social networking sites (MySpace, Facebook, LinkedIn)
- Wikipedia
- You Tube
- Blogs
- Chat Rooms
- Twitter



Tweet, Trade, Tweet

"Traders, analysts and farmers are using the 140-character online Twitter messages, called 'tweets,' to share information about fundamentals, offer instant reaction to market moves and to publicize their businesses."

Source: *For Traders, Twitter Is One More Trading Tool*, Wall Street Journal, August 3, 2009.

Questions