

## SEC Exam Staff Issues Its First ComplianceAlert

June 18, 2007

On June 14, 2007, the SEC's Office of Compliance, Inspections, and Examinations (OCIE) issued a ComplianceAlert, the first in what it has indicated will be a series of periodic updates that will summarize select areas that SEC examiners have found during examinations of broker-dealers, investment advisers, and investment companies. 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. Additionally, the ComplianceAlert suggests a number of practices that the OCIE found exemplary and 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, but that may serve as the basis for enforcement referrals in the future.

Some of the more notable aspects of the letter are summarized below.

### Mutual Funds

*Closed-End Fund Distributions.* The SEC staff noted that many funds that paid a return of capital pursuant to a managed distribution policy failed to send shareholders an appropriate Rule 19a-1 notice with the distribution that included a return of capital component.

*Mutual Fund "As Of" Transaction Practices.* The SEC staff found that many of the fund complexes examined had inadequate policies and procedures to mitigate the risks inherent in as-of transactions, and that often a fund's board of directors had not reviewed or approved the policies and procedures. Moreover, the SEC staff found that where intermediaries were permitted to enter as-of transactions, many fund complexes did not have sufficient controls in place to review the legitimacy and effect of such transactions.

### Investment Advisers

*Performance Advertising.* The SEC staff found a number of deficiencies with respect to adviser advertisements, including (i) lack of appropriate disclosures to prevent the advertisement from being misleading, (ii) lack of policies and procedures governing marketing and performance advertising or policies and procedures that did not appear to be effective, (iii) inappropriate use of a prior adviser's performance record, and (iv) inappropriate claims of compliance with CFA Institute performance presentation standards.

*Disaster Recovery Plans.* The SEC staff noted that in response to hurricane Katrina, many advisers in the affected areas effectively implemented their disaster recovery plans, and the SEC staff highlighted a number of practices that were particularly effective in this process.

### Broker-Dealers

*Sales of Section 529 Plans, Collateralized Mortgage Obligations, and REITs.* The SEC staff noted that many firms examined lacked adequate written supervisory procedures with respect to the sales of these products. Moreover, the SEC staff noted the some of these products were sold to investors without adequate disclosures.

*Regulation SHO.* The SEC staff noted that many firms examined lacked adequate written supervisory procedures to ensure that securities transactions are correctly marked long or short and to ensure that a locate of securities is performed in connection with short sales.

*Charges in Separately Managed Accounts (SMA).* The SEC staff found instances in which customers had been overcharged for SMA fees in a significant number of accounts.

*Part-Time Financial and Operations Principals (FinOps).* The SEC staff found increased instances of noncompliance with applicable regulations where firms employed a part-time FinOps.

*Expense-Sharing Arrangements.* The SEC staff noted that some firms that have implemented expense-sharing arrangements with an affiliate appeared to have failed to maintain the required minimum net capital, which resulted from inappropriate shifting of liabilities from the broker-dealer to an affiliate. Moreover, the SEC staff found that in certain instances, these arrangements were not properly documented in an adequate expense-sharing agreement.

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

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