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A legal update from Dechert's Financial Services Group

SEC Holds National Outreach Seminar for CCOs of Investment Advisers, Investment Companies

On November 8, 2005, the Securities and Exchange Commission (the "SEC") sponsored the CCOutreach National Seminar for investment adviser and investment company Chief Compliance Officers ("CCOs").[1] The purpose of the seminar was to allow the SEC and its staff to better communicate and coordinate with CCOs of advisers and mutual funds on topics CCOs wanted to address, following similar CCO outreach seminars conducted on a regional level.

Registered investment advisers and registered investment companies are required to adopt a written compliance program pursuant to Rule 206(4)-7 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and Rule 38a-1 under the Investment Company Act of 1940, as amended (the "Company Act"), respectively.[2] Moreover, Rule 206(4)-7 and Rule 38a-1 require that an adviser and investment company appoint a CCO to administer the adviser's and fund's compliance policies and procedures.[3]

Hedge fund managers that are in the process of registering as investment advisers with the SEC pursuant to Rule 203(b)(3)-2 under the Advisers Act will also be required to adopt a written compliance program and to appoint a CCO pursuant to Rule 206(4)-7.[4] Non-U.S.-based advisers that are registering with the SEC but are following the "Regulation Lite" regime are not required to adopt a written compliance program or to appoint a CCO.[5] Nevertheless, the topics discussed at the seminar remain relevant because registered non-U.S.-based advisers are subject to the anti-fraud provisions of the Advisers Act and to inspection by the SEC staff.

Key Considerations for CCOs

Based on the issues discussed and the practices described, CCOs of registered investment advisers and registered investment companies should consider the following:

- Be proactive. When a problem is identified internally, the CCO should undertake immediate steps to correct the problem, and revise the compliance policies and procedures as appropriate. Address the issue contemporaneously, as opposed to waiting to address the problem at the time of the annual review of the compliance program.

- Review the compliance program and operations for potential conflicts of interest. The SEC has made it clear that areas where conflicts of interest may exist will be closely examined. Conflicts of interest may likely arise in the following areas:

  - The allocation of investments and side-by-side management

  - Soft dollars

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1 Panelists at the seminar included SEC officials and CCOs from mutual fund complexes and investment advisory firms. A webcast of the seminar can be accessed at http://www.connectlive.com/events/ccoutreach/.

2 *See* Release No. IA-2204 (December 17, 2003) (the "Compliance Rule Release").

3 *See* Rule 206(4)-7(c) under the Advisers Act and Rule 38a-1(a)(4) under the Company Act.

4 *See* Release No. IA-2333 (December 2, 2004).

5 See supra note 4.

- Performance fees
- Valuation
- Agency and cross trades
- Principal trades
- Personal trading
- Proxy voting

- Document the CCO's review and what steps were undertaken to improve the organization's compliance program.
- Review of an organization's compliance program is a constant process. An adviser's or mutual fund's compliance policies and procedures manual is not a static document; it should reflect the dynamics of the market place and the organization's operations. As rules and regulations change, and an organization's business evolves, the compliance program should be revised accordingly.
- Pay particular attention to the firm's valuation policy. A CCO should work with the portfolio manager and others in the business unit in drafting the valuation policy. It will be important to have the valuation process be as transparent as possible. Documentation in support of valuation, especially illiquid securities and complex products such as derivatives, will likely be critical.

The following is a more detailed summary of the key issues discussed at the seminar.

Panel I: The Role of the CCO and the Annual Review

Role of the CCO

In the Compliance Rule Release, the SEC staff stated that the CCO should have sufficient seniority and authority to compel others to adhere to the compliance policies and procedures. The SEC staff also stated that the designation of a CCO should enhance the efficiency of funds' and advisers' operations by centralizing responsibility for the compliance function. Those themes were emphasized at the seminar.

A recurring phrase shared by the panelists is that the CCO be "empowered to compel compliance" and be "the focal point for compliance." According to Gene A. Gohlke, Office of Compliance Inspections and Examinations of the SEC, somebody has to be in charge and be "a single point where compliance comes to rest." The CCO is to "manage" the compliance program and it is the business unit that executes compliance. In other words, the CCO is to facilitate the ability of others to carry out their compliance responsibilities.

Communication between the CCO and senior management and the board of directors of funds is critical. The CCO should have direct access to senior management and to directors. Also, the CCO should keep senior management and directors apprised on a real-time basis and not necessarily wait for the annual report with respect to compliance issues.

The CCO should also have the full backing of senior management. Having senior management "buy in" to the compliance program sends a strong signal to all employees of the adviser or the fund that the organization is committed to compliance and therefore, everyone is expected to adhere to the organization's policies and procedures.

Hiring a Service Provider to Serve as the CCO

The SEC recognizes that small advisers may hire a consultant to serve as the CCO. Robert Plaze, Division of Investment Management of the SEC, gave the example of a small hedge fund run out of the office of a prime broker. In such a situation, the prime broker could be in the position to provide the CCO.

However, Mr. Gohlke expressed reservations about whether an employee of a service provider being a CCO on a part-time basis can truly be effective, and questioned whether a part-time CCO could be empowered to monitor and compel compliance.

Some participants suggested that a part-time CCO would be ineffective, noting how important it is to be physically present at the office and on the trading floor. By being physically present, a CCO quite often hears or sees things that could become a problem, but is there to address them.

SEC Staff Expectations of the CCO

A concern of the industry is whether being the CCO is tantamount to wearing a bull's-eye that the SEC then targets for an advisory firm's or fund's failures or viola-

tions. Mr. Plaze noted that the CCO does not perform the activities that traditionally get people in trouble, such as trading. He noted that in SEC enforcement actions where a CCO has been sanctioned, the CCO was performing other duties, such as doing price reconciliations. According to Mr. Plaze, what gets the CCO in trouble is when the CCO participates in the fraud, facilitates the fraud, or attempts to cover up the fraud.

Hallmarks of a Robust Program

It is important to identify a problem quickly after it occurs and to correct the problem as soon as possible. When the SEC staff conducts a routine exam, OCIE will ask for a list of material compliance issues. SEC examiners will look to see how each problem was resolved or is being resolved.

Annual Review

Advisers and mutual funds are required to review their policies and procedures annually to determine the adequacy and effectiveness of their implementation.[6] The annual review is an opportunity to look back to check whether something was missed. The annual review can be characterized as a survey in which the CCO should address the following:

- What has changed?
- Should compliance policies change?
- What were the failures?
- What did the firm do to correct the failures?

Panel II: Exams and Inspections

The Examination

The CCO is the point person during the exam. The SEC does not expect the CCO to know all the answers. However, the SEC expects the CCO to know where to go to get answers and obtain requested documents.

The SEC will likely interview the head of trading, the head portfolio manager, the CFO, the head of marketing and the person responsible for fund pricing. The examination staff will focus its attention on compliance controls and management oversight.

Areas of Focus

When reviewing the compliance program, the SEC examiners will review the program as a whole "from 40,000 feet" and then assess the program for any risks. The SEC examiners will focus on certain areas where they see conflicts of interests arising. In addition, there are several core areas that are examined: anti-money laundering; business continuity; trading, execution, and soft dollars; advertising and marketing; personal trading; and allocations of investment opportunities.

Common deficiencies cited are performance advertising, soft dollars, and the allocation of investment opportunities. On soft dollars, advisers should pay more attention as to what they are paying out and tie it to the value of the research received. On the allocation of investment opportunities, the SEC examiners will review the trade blotters, and the internal analysis in support of allocation decisions.

Tone at the Top

When reviewing the compliance program, the SEC examiners will consider the tone at the top. With respect to a small adviser, this means assessing the key individuals of the adviser.

When interviewing a key individual, the SEC staff will assess the following:

- What is the person's view regarding compliance?
- Does the person have respect for compliance?
- Is there an emphasis on ethical behavior?
- Is compliance something that is out of sight, out of mind, or is it something that the person thinks about?
- Is this person forthcoming or obstinate during the interview?

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6 *See* Rule 206(4)-7(b) under the Advisers Act and Rule 38a-1(a)(3) under the Company Act. Mutual funds are subject to the additional requirements that the fund review the policies and procedures of their service providers. Also, the CCO of a mutual fund must submit its annual report to the fund board for review.

Deficiency Letters

With respect to response letters, the SEC prefers that a senior officer respond to the deficiency letter and sign the response letter. The SEC expects that the person writing the response letter is the one taking responsibility for the changes being implemented after deficiencies have been identified by the SEC staff. The SEC does not like a response letter that is drafted in general terms stating that "we will address X, Y, and Z." The SEC prefers that the response letter describe the actions that have already been undertaken in response to the deficiencies and any actions that the adviser is planning to take.

Panel III: Trading and Market Issues

Soft Dollars/Best Execution[7]

The panelists gave a "real world" account on how their respective firms assess soft dollars and best execution.

One panelist stated that his firm has a Brokerage Review Committee. The Brokerage Review Committee consists of the chief trader, the CCO, and representatives from operations, legal, and compliance. Detailed minutes are taken. The issues that the Brokerage Review Committee addresses include trades during the past quarter, the costs of execution, the percentage of soft dollars allocated, the percentage of hard dollars allocated, and the research received. When the cost of an execution is higher than usual, the Committee reviews the reasons why—was it because it was a difficult trade or because credit was given by the broker?

A second panelist stated that her firm also has a soft dollar/best execution committee. The committee consists of representatives from research, trading, compliance, and marketing. The committee rates each broker-dealer used, including such factors as the research received, the availability of the analyst, the market strategy, the quantitative research, and the technical research. The committee also reviews the soft dollar budget.

During an SEC examination, with respect to brokerage review committees, the staff reviews what topics are addressed and examines the minutes of the committee. Also, the SEC examiners check whether there are controls in place to monitor execution.

Advisers and funds should consider and address the following areas:

- Client directed brokerage
- Use of commission funds to pay for fund distribution or client referrals
- Products and services received from brokers in addition to trade execution
- Mixed use products
- Use of affiliated brokers
- Use of step out trades
- Use of introducing brokers and commission sharing arrangements

With respect to mixed use products, the SEC examiners will review the allocation between research and non-research, as well as evidence that the allocation was appropriate, accurate, and documented. Furthermore, they will examine the adequacy of disclosure and will look to see if there are soft dollar products and services that are not being disclosed.

Panel IV: Other Regulatory Issues

E-mail

The staff noted that electronic documents are not treated differently from paper documents. Moreover, the SEC staff has access to all documents maintained by an adviser pursuant to Section 204 of the Advisers Act.

The SEC typically will not request that e-mails be produced at the beginning of an examination. Rather, after reviewing the adviser's or fund's compliance activities, and having identified areas that warrant a more in-depth review, the staff will submit a secondary request

[7] Note that conventions governing the use of soft dollars may change in the near future. The SEC published for comment a proposed interpretive release with respect to client commission practices under Section 28(e) of the Securities Exchange Act of 1934, as amended. *See* Release No. 34-52635 (October 19, 2005). The U.K. Financial Services Authority recently adopted new rules governing the use of "soft commissions" in July 2005. *See* U.K. Financial Services Authority, Policy Statement 05/9, Bundled Brokerage and Soft Commission Arrangements: Feedback on CP 05/5 and Final Rule (July 2005). *See also Dechert Onpoint: SEC Releases Interpretation of Soft Dollar Usage by Money Managers* (Nov 2005 / Issue 23).

whereby the SEC will request the e-mails of persons involved in key areas identified by the staff.

Participants noted that there is a cost to retain e-mail, and it is a business decision to either sort out e-mail to determine what to retain or to keep it all. The panelists concluded that it would be reasonable for an adviser or fund to use a sampling process to review a batch of e-mails on a periodic basis to ensure that required records that need to be maintained are not being destroyed.

It was noted that a firm would be at a "heightened risk" if it was not reviewing e-mail. A suggested means to monitor e-mail is through sampling. For example, a firm would identify certain persons who are at a higher risk to abuse e-mail or to participate in a scheme that harms clients and then periodically review their e-mail. Another suggested means of monitoring e-mail would be to review a random sample of e-mails of various employees.

Code of Ethics[8]

The panelists gave "real world" examples of provisions included in their firms' code of ethics.

One panelist stated that in addition to what is statutorily required in a code of ethics, her firm also imposes restrictions on gifts, which is a best practice. As part of the restrictions on gifts, employees are required to complete a gifts log.

A second panelist described the blackout period restrictions applicable to the personal trading of employees. A staggered tiered policy applies: non-trader employees are subject to a one day blackout, and portfolio managers, traders, and analysts are subject to a seven day blackout period. Also, if a security is part of the portfolio or is under consideration, then an employee may not trade that security.

SEC staff members indicated that they preferred that personal securities transaction reports be maintained in electronic format as opposed to paper format, especially if the adviser or fund is a large organization. Maintaining personal securities transaction reports in electronic format facilitates the comparison of the holdings of an access person's personal trading against a fund's portfolio or client's account.

Form ADV

CCOs should expect to receive reminders via e-mail that Part I of Form ADV is to be updated prior to the annual update deadline.[9] The SEC will also communicate reminders, changes of law, and notices to CCOs via e-mail. In addition, the SEC staff will issue a periodic newsletter, the "*CCObserver*," that will address issues of interest to CCOs—new rules, interpretive releases, recent examination findings, and relevant enforcement actions.

The SEC staff also indicated that when the revised Part II is released, it will be entirely in narrative format.

AML

The SEC staff indicated that the U.S. Treasury may move forward on final rules to require investment advisers and unregistered investment companies to adopt an anti-money laundering program.[10]

Valuation

The SEC will assign a risk rating to an adviser's or fund's valuation policy. The rating is based on the composition of the fund's portfolio. A portfolio that is composed of exchange traded U.S. equity securities would be considered low risk. A portfolio that is composed of a broad range of securities—publicly traded, thinly traded, U.S. securities, non-U.S. securities, futures—would be treated as high risk. If a portfolio is characterized as being high risk, even if the valuation controls are good, the SEC examiners will closely scrutinize the valuation policy.

[8] Registered investment advisers and registered investment companies are required to adopt a code of ethics. *See* Release No. IA-2556 (July 2, 2004). Note that registered non-U.S.-based advisers that are complying with the "Regulation Lite" regime are required to retain their access persons' personal securities reports that are required pursuant to Rule 204A-1 under the Advisers Act. *See supra* note 4.

[9] A registered investment adviser is required to amend Part I of Form ADV at least annually, within 90 days of the adviser's fiscal year end. *See* Rule 204-1(a)(1) under the Advisers Act.

[10] *See* Financial Crimes Enforcement Network; "Anti-Money Laundering Programs for Investment Advisers"; proposed rule. 68 Fed. Reg. 23646-23653 (May 5, 2003) and Financial Crimes Enforcement Network; "Anti-Money Laundering Programs for Unregistered Investment Companies"; proposed rule 67 Fed. Reg. 60617-60625 (September 26, 2002).

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