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A legal update from Dechert's Financial Services Group

SEC Staff Issues Second *ComplianceAlert* for CCOs

On July 22, 2008, the Securities andExchange Commission's Office of Compliance, Inspections, and Examinations (OCIE) released its second *ComplianceAlert* letter identifying common deficiencies and weaknesses that OCIE examiners have found during recent compliance examinations of firms registered with the SEC.[1] The *ComplianceAlert* program is intended to foster robust compliance in the securities industry by providing information about deficiencies and encouraging chief compliance officers to take steps to address any similar issues at their firms.

The following is an overview of the issues discussed in the second *ComplianceAlert*.

Investment Advisers/Mutual Funds

Personal Trading by Advisory Staff

Examiners reviewed advisers' internal compliance controls with respect to employee trading and trading by advisers for their own proprietary accounts. Examiners found that advisers frequently exhibited the following deficiencies with respect to their internal compliance controls:

- Codes of ethics were incomplete or not followed, and supervision of investment personnel was weak (including, as an example, situations in which investment personnel disclosed sensitive information to personnel at other advisory firms).
- Reporting requirements were not complied with and/or monitoring was not performed.
- Advisers' brochures (Form ADV Part II) contained inaccuracies with respect to controls over personal trading.

Examiners also observed several practices that appeared to be effective in preventing violations. Such practices included the implementation of policies and procedures designed to address conflicts of interest and the periodic reporting of code of ethics violations to funds' boards of directors. For example, examiners observed that many of the advisers that maintained effective compliance programs had compliance personnel that were actively involved in implementing those programs.

Proxy Voting Oversight and Operations

Examiners found that most advisory firms had adopted policies and procedures with respect to proxy voting as required under the proxy

1 OCIE released its first *ComplianceAlert* on June 14, 2007. The recent letter is available at http://www.sec.gov/about/offices/ocie/complialert0708.htm. The prior letter is available at http://www.sec.gov/about/offices/ocie/complialert.htm.

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voting rule.[2] However, examiners observed that, in certain instances, proxy voting policies and procedures seemed to contain inaccurate information or were not followed. Examiners noted the following deficient practices with respect to proxy voting:

- Board oversight of proxy service providers appeared to be weak.
- Documentation regarding adviser assessments of proxy service providers was lacking.
- Funds voted inconsistently with their proxy voting policies.
- Funds did not file Form N-PX setting forth the funds' proxy voting record.
- Registration statement disclosures regarding proxy voting policies and procedures appeared deficient.
- Improper fees were charged (*e.g.*, use of soft dollars to pay for proxy voting services unrelated to issuer research without adequately disclosing this practice and allocation of proxy service fees to funds when the fund did not hold voting securities that would require such services).

Valuation and Liquidity Issues in High Yield Municipal Bond Funds

Examiners reviewed valuation and liquidity issues with respect to high yield municipal bond funds.[3] In a series of targeted examinations, examiners observed the following:

- 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.
- High yield funds often did not disclose the increased risk with respect to liquidity and valuation, as required.
- Pricing services often relied on fund management to provide information needed to value securities held by high-yield funds. Examiners noted that the fund's disclosure may be misleading if, in such instances, the fund represented that its pricing source provided "independent" values.
- With respect to cross trades, examiners found that documentation supporting advisers' determination that the evaluated prices provided by the pricing services and used to cross the trades was insufficient in some cases.
- Some funds did not adequately assess the accuracy of prices provided by pricing services.
- Certain funds failed to maintain adequate records with respect to pricing histories for portfolio securities.

Soft Dollar Practices of Investment Advisers

Examiners 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 (i) 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; (ii) advisers' disclosure concerning soft dollar practices; and (iii) soft dollar policies and procedures. Examiners observed the following regarding soft dollar practices:

- Generally, soft dollar arrangements with broker-dealers included both proprietary and third-party products and services. The most common arrangements were research and trade execution assistance products and services. Many advisers received "mixed-use" products or services and a few advisers received products and services

2 Pursuant to Rule 206(4)-6 under the Investment Advisers Act of 1940, as amended, advisory firms that exercise voting authority with respect to client securities must adopt and implement proxy voting policies and procedures that are reasonably designed to ensure that the advisory firm votes proxies in the best interest of its clients. Such policies and procedures must describe how the advisory firm addresses material conflicts between its interests and those of its clients with respect to proxy voting.

3 Valuation with respect to high yield municipal bond funds is important because many of these funds invest in securities that trade in the secondary market on an infrequent basis or never trade in the secondary market. The *ComplianceAlert* notes 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 of 1940, as amended. OCIE's observations in the high yield municipal bond area have implications for other portfolio assets that may be illiquid or otherwise difficult to price. Advisers should review the Commission's Administrative Order in *In the Matter of Heartland Advisors, Inc., et al.* (Administrative Proceeding File No 3-12936 (January 25, 2008)) for helpful guidance concerning valuation of high yield municipal bonds and difficult-to-price securities.

outside those that are defined in the safe harbor under Section 28(e) of the Securities Exchange Act of 1934.

- All of the advisers examined that 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.

- Most advisers documented their efforts to seek best execution, and those who relied on the Section 28(e) safe harbor made determinations that commissions were reasonable in light of the brokerage and research services received.

- Most advisers that received soft dollars appropriately disclosed that they did so. Examiners noted, however, that some advisers did not disclose potential conflicts of interest, such as their receipt of soft dollar research from a company in which an affiliated person had an ownership interest.

- Many advisers had policies and procedures related to soft dollar practices. Examiners noted that effective soft dollar 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.

Broker-Dealers

Examinations of Securities Firms Providing ''Free Lunch'' Sales Seminars

In a series of over 100 examinations, the Financial Industry Regulatory Authority (FINRA), the North American Securities Administrators Association, and the SEC reviewed the practices of broker-dealers, investment advisers, and other financial services firms that offer so-called "free lunch" sales seminars frequently targeted to seniors. Examiners generally observed that the seminars were intended to result in the attendees' opening new accounts with the sponsoring firm and, ultimately, purchasing 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. Examiners observed that some firms had particular compliance and supervisory controls that appeared to be effective. However, in half of the examinations conducted, examiners found that advertising and sales materials may have been misleading or exaggerated or included seemingly unwarranted claims. Examiners noted that 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.

Valuation and Collateral Management Processes

In coordinated examinations with FINRA, SEC examiners reviewed select large broker-dealer firms with respect to valuation and collateral management practices as they relate to subprime mortgage-related products. These examinations generally focused on the controls around the valuation process. The following issues were noted by the examiners:

- Certain processes appeared to be of questionable merit or failed to be sufficiently vigorous in undertaking the price verification function (*e.g.*, 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 overly manual procedures).

- In certain cases, independent product control groups were highly reliant upon trading personnel for valuations due to insufficient staff and/or were staffed with individuals with limited experience in validating modeled prices.

- Documentation with respect to policies and procedures for verifying inventory valuations was insufficient or inadequate.

- In certain cases, product control groups were not routinely engaged in assessing the valuation of collateral.

- There were instances of inconsistent pricing between the same securities held in inventory and also held as collateral for financing transactions with counterparties.

- Processes surrounding the issuance and resolution of margin calls were not established, adhered to, and/or adequately documented.

The *ComplianceAlert* provided several examples of "strong control practices" with respect to valuation and collateral management processes. These practices included employing processes and procedures that are aligned with market conditions, adequately staffing product control groups with experienced and knowledgeable members, establishing standards and documentation to support the valuations appearing on their financial statements, involving independent product control groups to monitor collateral valuations, maintaining an internal data warehouse that serves as the internal repository for security position information, and ensuring that price verification, collateral management, and margin call processes and procedures are adequately documented and contain enough specificity to ensure consistent application.

Broker-Dealers Affiliated with Insurance Companies

Examiners conducted targeted reviews of a number of broker-dealer subsidiaries of insurance companies. These 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. Examiners also noted deficiencies in firms' compliance with the financial responsibility requirements for broker-dealers and identified the need for net capital adjustments. Examiners observed that 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, and reviewed, among other things, how supervision was implemented for these registered representatives' activities as solicitors. The examiners observed in certain cases 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. Examiners also observed that 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 addition, examiners found that some of the broker-dealer firms used apparently false and/or misleading advertising and sales literature, did not file their sales material with the NASD (now FINRA), and/or 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

Examiners conducted a risk-targeted examination of broker-dealer firms to evaluate the practice whereby a broker-dealer recommends to customers that they finance the purchase of securities by obtaining a second or reverse mortgage on their home through a bank affiliated with the broker-dealer. Although examiners 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, some firms, nonetheless, have maintained incentive programs for registered representatives to refer customers to an affiliated bank for a mortgage. Examiners indicated that supervision and record-keeping relating to these activities appeared to be poor, and 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. Examiners noted that 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. 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.

Transfer Agents

Practices with Respect to ‘‘Lost Securityholders’’

Examiners reviewed transfer agents 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. Examiners observed that 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. Examiners noted that 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.

Examiners also found that some transfer agents inappropriately refused to deal with securityholders who attempted to correct their addresses on the transfer agents’ records and search firms retained by a transfer agent charged securityholders fees during the “free search” phase.

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