

**THOMPSON
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**INVESTMENT MANAGEMENT
UPDATE****July 2008 SEC ComplianceAlert**

The staff of the Securities and Exchange Commission (SEC) recently published a *ComplianceAlert*¹ describing certain areas reviewed by SEC examiners during examinations of SEC-registered investment advisers, investment companies, broker-dealers and transfer agents. The *ComplianceAlert* identifies issues found by the examiners during the examinations and those practices the SEC believes may help to prevent securities law violations. This bulletin provides an overview of the *ComplianceAlert*.

INVESTMENT ADVISERS/MUTUAL FUNDS***Personal Trading by Advisory Staff***

During examinations, SEC examiners often focused on the compliance controls investment advisers established relating to trading by an adviser's staff and trading by the adviser for its own accounts. Examiners frequently cited the following areas of non-compliance:

- *Incomplete Codes of Ethics.* Advisers' codes of ethics that failed to address all of the regulatory requirements (e.g., failure to require access persons to obtain pre-approval for investments in hedge funds, private placements or IPOs).
- *Failure to Adhere to Codes of Ethics.* Advisers and their employees failed to follow the code of ethics. Specifically, examiners commented when they felt an adviser had ineffective controls relative to the supervision of investment personnel.
- *Reporting/Monitoring Requirements Not Followed.* Investment personnel failed to submit reports of their personal trades in a timely fashion. Also, examiners commented that compliance officers did not review trading reports to confirm that the adviser's compliance procedures were followed.
- *Inaccurate Disclosure.* Advisers' marketing materials inaccurately described control procedures over personal trading.

SEC examiners identified the following procedures and controls as potentially effective in preventing violation of Investment Advisers Act provisions regarding personal trading by access persons:

- Implementation of compliance policies and procedures designed to deal with conflicts of interest that might arise when trading in personal and proprietary accounts.
- Use of restricted and watch lists.
- Use of time-stamped order tickets.



- Requirement that all personal trades are handled by the adviser's trading desk and client trades are made before, or with, personal trades.
- Strict enforcement of "black-out" periods.
- Use of approval and pre-clearance forms for personal trades; forms compared to the actual trades made by the adviser's employees.
- Establishment of procedures to prevent insider trading.
- Implementation by compliance officers of procedures for personal trading and enforcement of the code of ethics. Violations of advisers' personal trading policies treated seriously and the offending employees punished.
- Requirement that advisers report code of ethics violations to the board.

Proxy Voting and Funds' Use of Proxy Voting Services

SEC examiners reviewed and commented on proxy voting policies and procedures and advisers' use of third-party proxy voting services. The SEC staff found that funds usually monitored proxy voting through an oversight process involving, in part, board review of the proxy voting policy and Form N-PX. Interestingly, examiners also found that some advisers chose to form a standing proxy voting oversight committee to maintain compliance with proxy voting procedures. Furthermore, examiners found that most advisers developed proxy voting policies designed to identify conflicts of interest related to proxy voting. While the examined funds and advisers generally followed proxy voting policies, examiners identified the following problems:

- *Weak Board Oversight of Proxy Service Providers.* Some funds failed to establish or maintain controls to ensure that proxy service recommendations were consistent with the fund's proxy voting policies and procedures.
- *Failure to Document Assessment of Proxy Service Providers.* Because some advisers failed to document their review of proxy service providers, examiners could not determine whether the advisers implemented procedures intended to identify proxy service providers' conflicts of interest.
- *Inconsistent Voting.* Some funds voted in a manner inconsistent with their written proxy voting policies.
- *Failure to File Appropriate Form N-PX.* Examiners found that some Forms N-PX did not contain necessary information (e.g., no record of all votes cast, vague descriptions of voted-on matters, etc.).
- *Deficient Proxy Voting-Related Disclosure.* Some funds failed to disclose their proxy voting procedures in the Statement of Additional Information.
- *Improper Fees.* Examiners found that some advisers improperly allocated proxy service fees to funds that did not use the proxy services and other advisers failed to disclose the use of soft dollars for proxy voting services.



Valuation and Liquidity Issues in High-Yield Municipal Bond Funds

While examining high-yield municipal bond funds, the SEC staff focused on portfolio composition, valuation and transaction activity. The examiners noted the following valuation issues:

- *Portfolio Composition.* Examiners raised fewer liquidity concerns with regard to high-yield funds that had high average credit qualities, limited unrated bonds and fewer distressed and defaulted bonds. Examiners also noted greatly varying percentages of illiquid bonds held by these funds, ranging from 1 percent to 70 percent of total assets.
- *Disclosure.* High-yield funds often failed to disclose the heightened valuation and liquidity risks associated with investing in high-yield securities.
- *Third-Party Pricing.* In order to “fair value” securities held by high-yield funds, boards of directors often rely on third-party pricing services. However, examiners noted that pricing services rely on the adviser to provide the information forming the basis for the valuation. Examiners warned that if a fund provides information in this manner, it should be careful not to label the securities valuations as “independent.” Also, examiners noted that funds were sometimes unable to sell securities at or near the price determined by the pricing service, and that funds should consider this liquidity/pricing issue when evaluating third-party valuations.
- *Cross-Trades.* Cross-trading of high-yield securities among client accounts can create conflicts of interest. Examiners noted that the few high-yield bond funds that cross-traded fair-valued bonds often were unable to provide documentation showing that the fund’s evaluation of the prices used in the cross-trades represented market value.
- *Board Oversight.* Fund boards of directors are obligated to evaluate the accuracy of valuations provided by third-party pricing services. Examiners noted that some funds failed to adequately evaluate third-party pricing. High-yield funds that documented and reviewed communications between portfolio management and pricing services proved more successful in evaluating third-party pricing services.
- *Records Retention.* Examiners noted that maintaining electronic pricing histories can significantly aid fund personnel and boards of directors in their review of valuation issues and pricing patterns.

Soft-Dollar Practices of Investment Advisers

The *ComplianceAlert* reports that SEC examiners have recently focused on soft-dollar arrangements with the goal of better understanding “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; the disclosures advisers provide to their clients regarding soft dollar practices; and the policies and procedures that advisers who receive soft dollar benefits use to meet their fiduciary duty to seek best execution.” During this review of soft-dollar arrangements, examiners noted the following:



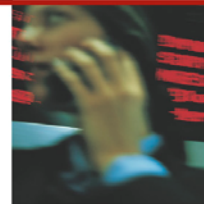
- *Products and Services.* Broker-dealers provide both proprietary and third-party products to advisers, most often in the form of research and trade execution assistance. The staff noted that advisers often received “mixed-use” products and services.
- *Total Commissions Directed.* All examined advisers with soft-dollar arrangements indicated that they had commission “targets” with broker-dealers. While the percentage of total client commissions directed to broker-dealers in soft-dollar arrangements varied greatly (from 3 percent to 100 percent), the average adviser allocated 20 percent of total client commissions to broker-dealers in soft-dollar arrangements.
- *Best Execution.* Examiners noted that most advisers maintained appropriate documentation of their best execution analyses. Specifically, the staff found that advisers often conducted periodic best execution reviews. As might be expected, examiners noted that some advisers’ best execution reviews were better than others. Furthermore, examiners found that a few advisers had large soft-dollar credit balances (*e.g.*, millions of dollars in value). These sorts of large soft-dollar credit balances led examiners to question whether commissions paid may not have been reasonable.
- *Disclosure.* Examiners noted that advisers generally disclosed appropriate information regarding the types of research and services received from soft-dollar arrangements and the potential for conflicts of interest because of soft-dollar arrangements. However, examiners did comment when advisers failed to disclose conflicts of interest and when advisers acquired products and services outside of the Section 28(e) safe harbor, such as internet domain fees, BlackBerry service and computer equipment.
- *Compliance Policies, Procedures and Controls.* Most reviewed advisers maintained compliance procedures relative to soft-dollar arrangements. Examiners found that effective procedures mandated that advisers maintain reports of soft-dollar arrangements and transactions, reconcile commissions on a periodic basis, review mixed-use product allocation and ensure that the chief compliance officer or committee pre-approve specific products and services acquired with soft dollars.

BROKER-DEALERS

The *ComplianceAlert* addresses a number of issues of interest to broker-dealers, including “free lunch” seminars, valuation and collateral management practices, broker-dealer/insurance company affiliation, supervision of solicitation of advisory services, mortgage financing credit and the office of supervisory jurisdiction structure.

Examinations of Securities Firms Providing “Free Lunch” Sales Seminars

The *ComplianceAlert* reports that in an effort to protect senior citizen investors, the SEC and other securities regulators conducted numerous examinations of broker-dealers, advisers and other firms that offer “free lunch” sales seminars. “Free lunch” seminars are investment seminars to which firms attempt to attract prospective investors by offering free meals and other incentives (*e.g.*, door prizes,



free books or vacation deals). These seminars are often marketed in ways intended to attract senior citizens and while many are advertised as “educational” or “instructional,” examiners found that most of the seminars were intended to sell securities like variable annuities, REITs, mutual funds and private placements of speculative securities. Some of the issues raised in the examinations include:

- *Some Effective Compliance Controls.* Examiners found that firms that reviewed all marketing materials for legal compliance had better success abiding by securities and other regulatory rules.
- *Misleading or Exaggerated Advertising Materials.* Many of the examinations discovered that firms sponsoring these seminars distributed marketing materials that may have been misleading or exaggerated. Regulators also noted that many broker-dealers failed to obtain Financial Industry Regulatory Authority (FINRA) review of marketing materials – a violation of FINRA advertising rules. Most commonly, marketing materials contained misleading statements regarding the safety, liquidity or predicted rates of return for particular investments.²
- *Attendees’ Misunderstanding of Seminar Sponsor.* Marketing materials promoting the seminars often did not clearly disclose that the seminar was sponsored by a financial institution (e.g., mutual fund or insurance company). As such, regulators determined that seminar attendees may not have fully understood that the individuals presenting the seminars were not making unbiased investment recommendations.
- *Poor Seminar Supervision.* At least half of the examinations revealed that firms sponsoring the seminars had poorly implemented (or non-existent) procedures to supervise their employees conducting the seminars.
- *Recommendation of Unsuitable Investments.* In a quarter of the examinations, examiners discovered that some of the firms recommended investments that were inappropriate for particular investors. For example, some firms recommended risky investments to self-described “conservative” investors.
- *Potential Fraud.* In 13 percent of the examinations conducted, some evidence of fraud was detected. Some of the fraudulent activities discovered included serious misrepresentation of risk and return and the sale of fictitious investments.

The report summarizing the regulators’ findings suggested that financial services firms should make every effort to carefully supervise seminars and take steps to review and approve all marketing and advertising materials.³ The report also encourages these firms to be sure that the investment recommendations made to seniors are appropriate for the prospective investor’s goals and risk tolerance.

Valuation and Collateral Management Processes

SEC staff, with assistance from FINRA, conducted examinations of some large broker-dealers to evaluate their valuation and collateral management practices related to subprime mortgage-related products. These examinations centered on valuation process control procedures. Examiners



discovered that decreased liquidity for subprime products led to broker-dealers relying more on price models than on third-party pricing services. Examiners made note of the following issues:

- *Price Verification Deficiencies.* Some firms failed to maintain appropriately stringent price verification procedures. Insufficient price verification procedures included the use of outdated information underlying valuations and the failure to use automated procedures.
- *Insufficient Staffing.* In some cases, the independent valuation control groups were too thinly staffed, or were staffed with inexperienced individuals.
- *Policies and Procedures.* Policies and procedures for confirming inventory valuations were not documented, not appropriately detailed or not adhered to.
- *Documentation.* Some examiners noted that firms failed to maintain documentation appropriate to substantiate valuations.
- *Verification of Collateral Prices.* In some instances, product control groups did not regularly determine the valuation of collateral. In some cases, the valuations for subprime securities held as collateral were provided by outside pricing services, rather than the product control group.
- *Inconsistent Pricing.* Occasionally, the examinations found pricing inconsistencies between securities held as collateral and the same securities held as inventory.
- *Margin on Collateral.* Examiners noted that some firms failed to establish or adhere to procedures regarding issuance and resolution of margin calls.

During the broker-dealer examinations, a number of strong control practices were also noted, including:

- *Adequate Staffing.* Product control groups are adequately staffed, both in terms of number of personnel and depth of experience. The product control groups at firms followed processes consistent with market conditions, including, but not limited to, processes that take into account the possibility of illiquid markets for subprime securities.
- *Established Information Management.* Firms follow established procedures regarding documentation supporting valuations appearing on the financial statements (*e.g.*, retaining inputs to models, cash flow analyses, valuation matrix assignments, etc.). Also, examiners found that firms with effective control procedures maintained a centralized data warehouse for information regarding security positions and valuations.
- *Written Control Procedures.* Examiners noted that documentation of price verification, collateral management and margin call processes and procedures, as well as a process for the written revision of those processes, formed the basis for effective control procedures.

Broker-Dealers Affiliated With Insurance Companies

The *ComplianceAlert* reports that examiners performed a number of reviews of broker-dealer subsidiaries of insurance companies.⁴ During these reviews, some examiners observed unsuitable



mutual fund and/or variable annuity transactions. Examiners also identified non-compliance with broker-dealer financial responsibility requirements. Examiners concluded that inadequate (or non-existent) compliance and supervisory controls were the root of many of the cited deficiencies. Perhaps unsurprisingly, some broker-dealers affiliated with insurance companies were supervised by insurance professionals with inadequate knowledge of securities laws and regulations.

Supervision of Solicitations of Advisory Services

Examiners also performed a number of examinations of broker-dealers that designate their representatives as solicitors for advisers. These examinations revealed that solicitors gave investment advice to customers and guided those customers' investment decisions. Examiners concluded that both the broker-dealer and the investment adviser failed to appropriately supervise the investment recommendations and advisory services that were provided. On a related note, some broker-dealers did not enforce written procedures to supervise solicitor recommendations. More seriously, examiners also discovered broker-dealers that used false or misleading marketing and sales materials and/or failed to file the required materials with FINRA.

Mortgage Financing as Credit for the Purchase of Securities

The *ComplianceAlert* reports that some examinations were conducted of broker-dealer firms that recommended that investors use second or reverse mortgages (obtained through a financial institution related to the broker-dealer) to fund the purchase of securities. This sort of arrangement, of course, creates the possibility that returns on investments may be insufficient to service the home loan and could result in default and foreclosure. Examinations revealed that broker-dealers commonly prohibit their representatives from suggesting that customers take out any sort of loan to fund securities purchases. However, examiners noted that broker-dealers inconsistently enforced their policies prohibiting loan recommendations. Furthermore, in a few instances, examiners questioned the suitability of loan recommendations.

Office of Supervisory Jurisdiction Structure

Examiners also reviewed broker-dealers' compliance controls under an office of supervisory jurisdiction (OSJ) structure. Specifically, examiners focused on firms' supervisory structure and practices. The most commonly cited deficiencies involved a failure of broker-dealers to adopt, implement or adhere to written supervisory policies and procedures. Also, examiners noted that broker-dealers operating under an OSJ structure often failed to maintain adequate records tracking items such as customer complaints, new account forms, order tickets, etc.



TRANSFER AGENTS

Practices With Respect to “Lost” Securityholders

The *ComplianceAlert* reports that examinations of transfer agents were performed to gain some insight into the practices used to locate “lost” securityholders.⁵ Examiners discovered that some transfer agents split part of the search fees that third-party search firms charged securityholders. This fee-sharing might create a conflict of interest to the extent it encourages transfer agents to use less than reasonable care to perform the required two initial searches for the lost securityholders. Examiners also noted that transfer agents occasionally wrongly refused to allow securityholders to change their address on record with the transfer agent.

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¹ *ComplianceAlert* (July 2008), available at <http://www.sec.gov/about/offices/ocie/complialert0708.htm>.

² The SEC noted statements such as “Immediately add \$100,000 to your net worth,” “How to receive a 13.3% return” and “How \$100k can pay 1 Million Dollars to Your Heirs.”

³ A public report regarding the examination of “free lunch” seminars can be found at <http://www.sec.gov/spotlight/seniors/freelunchreport.pdf>.

⁴ Broker-dealer subsidiaries of insurance companies were often created to sell products such as variable annuities and variable life insurance. Over time, some of these broker-dealers have grown to offer a full spectrum of broker-dealer services and products.

⁵ The *ComplianceAlert* notes that in order to attempt to track down “lost” securityholders, transfer agents must “exercise reasonable care to ascertain the securityholder’s correct address.” Also, transfer agents must use an information database service to perform at least two searches (at no charge to the securityholder).