Tom Giachetti on Staying Compliant Now • Jim Barnash on Mentoring the Young

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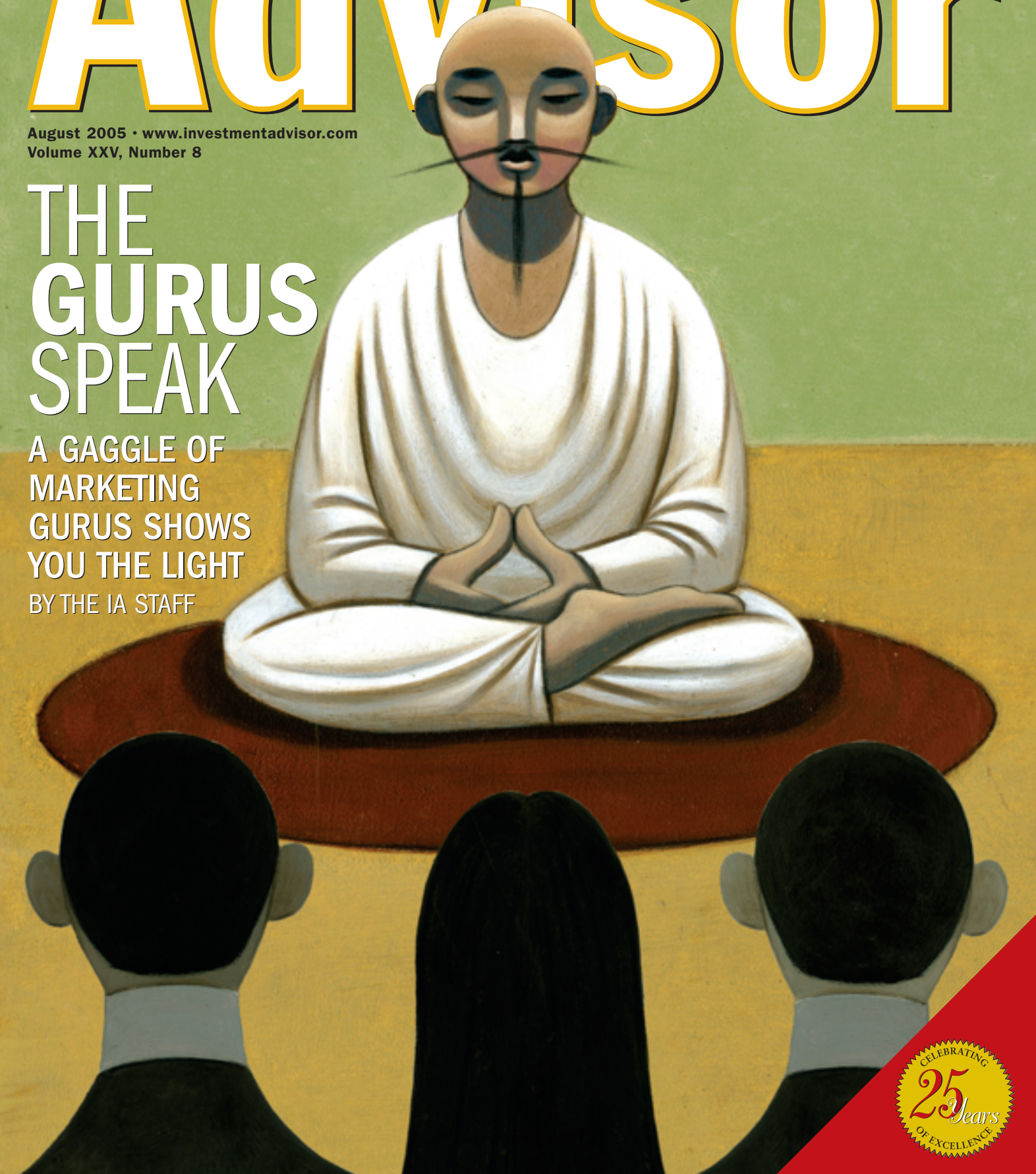
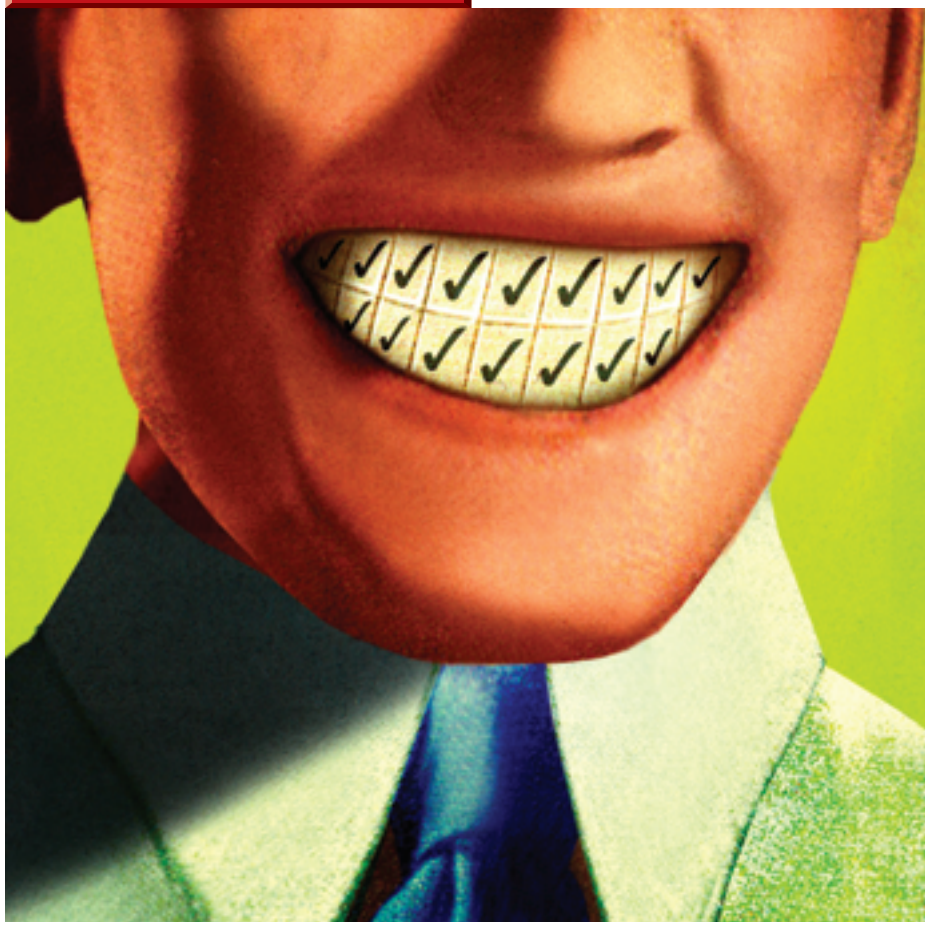
THE GURUS SPEAK

A GAGGLE OF MARKETING GURUS SHOWS YOU THE LIGHT

BY THE IA STAFF



CELEBRATING 25 Years OF EXCELLENCE



If you want to welcome an SEC examiner, get prepared now

By Thomas D. Giachetti, Esq.

Come Right In

With the advent of SEC rule 206(4)-7 requiring SEC registered investment advisors to implement and maintain policies and procedures appropriate for their investment advisory business, it is critical for all RIAs to recognize that compliance is an ongoing process that requires the review, updating, and amendment of regulatory filings, disclosures, and procedures. In this article, I will address issues pertaining to an advisor's compliance-readiness, including a list of some of the more substantive issues that are currently the focus of SEC examiners.

During an SEC regulatory examination, examiners will review various items, including compliance with recordkeeping requirements, soft-dollar and referral arrangements, regulatory and client disclosures, custody issues, performance reporting, advertising practices, trade errors, and conflicts of interest. In recent examinations, the commission has enhanced its review of "best execution" practices to include policies, procedures, and corresponding client disclosures relative to allocation, order "bunching," effecting transactions for client accounts through broker/dealers that refer clients to the advisor, directed brokerage arrangements, and IPO allocation practices.

In addition, a primary focus of current exams is the firm's compliance with rule 206(4)-7. The rule is designed to protect investors by requiring advisors to have internal programs to enhance compliance with the federal securities laws. Specifically, the rule requires SEC-registered investment advisors to adopt compliance policies and procedures designed to prevent violations of applicable securities laws, including the Investment Advisers Act of 1940; review their established policies and procedures for their adequacy and the effectiveness of their implementation at least annually; and designate a chief compliance officer to be responsible for administering policies and procedures.

The rule does not dictate specific policies or procedures. But it requires that they be reasonably designed to prevent violation of the Advisers Act. Thus, they need to encompass compliance considerations relevant to the operations of the advisor. The SEC recognizes that the inter-

Illustration: Brian Stauffer

nal compliance programs of small firms will be less complex than those of large ones. The policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and promptly correct any violations that have occurred.

Compliance is ongoing; advisors must review, update, and amend regulatory filings, disclosures, and policies

The First Steps

The SEC has indicated that each advisor, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks. The SEC further indicated that it would expect that an RIA's policies and procedures, at a minimum, should address the following key areas to the extent that they are relevant:

Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the advisor, and applicable regulatory restrictions.

Trading practices, including procedures by which the advisor satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar" arrangements), and allocates aggregated trades among clients.

Proprietary trading of the advisor and personal trading activities of supervised persons.

The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements.

Safeguarding of client assets from conversion or inappropriate use by advisory personnel.

The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction.

Marketing advisory services, including the use of solicitors.

Processes to value client holdings and assess fees based on those valuations.

Safeguards for the privacy protection of client records and information.

The most current SEC examination checklist addresses each of these key areas. Accordingly, an RIA firm must be prepared to demonstrate to the SEC that it has considered each such area and has implemented an appropriate corresponding policy to the extent applicable.

To be prepared for the day the SEC comes calling, the firm should be familiar with both the examination process and the issues that will be raised during the examination. One way to accomplish this is through mock regulatory examinations. We conduct them with advisors across the country to better prepare them for the regulatory examination process. By going through a mock examination, advisors are better able to address and correct current deficiencies and enhance current procedures, and, most importantly, recognize and avoid issues that could result in potentially adverse regulatory determinations or enforcement matters.

RIA Trouble Spots

In reviewing SEC examination results, several common deficiencies keep popping up. Among them are:

Prior deficiencies. Make sure that you have properly addressed all deficiencies cited in previous regulatory examinations. Depending upon the nature of the issue, failure to correct previously cited deficiencies can result in a referral to enforcement. To detect and prevent rccurrences, these issues should be reviewed by the chief compliance officer on a periodic basis.

Lacking an appropriate business continuity plan. The SEC is currently issuing deficiencies to RIA firms that fail to consider and account for emergency situations that have the potential to interrupt and interfere with their ability to effectively service investment advisory clients. Partly as a result of recent global and domestic events, the SEC mandates business continuity planning for all federally registered RIA firms. In fact, requests for such policies have become commonplace during regulatory audits. A firm's policy and any corresponding procedures will be reviewed for their adequacy and in relation to the firm's scope and complexity.

Some firms address business continuity issues by focusing solely upon information technology, such as computer backups and additional record retention software, while others focus upon personnel issues such as the incapacity of key employees. Regardless of the size or intricacies of the firm, each firm should balance these two considerations. The resulting business continuity plan should concentrate on reasonably foreseeable events and the potential impact each would have on the firm's business as well as its ability to service clients. The contingency planning process should include provisions that address the impact an emergency situation would have on various aspects of the firm's investment operations. These include—but are not limited to—employees, clients, physical facilities, communications, information resources, business operations, regulatory concerns, third-party service providers, and financial resources, and all within the context of losses to the firm's physical infrastructure, business operations, and personnel.

For example, physical losses relate to those tangible elements that comprise the firm's infrastructure. Business operational losses include those elements that serve as the foundation upon which the infrastructure relies, the firm's financial and information resources, as well as custodians or other third-party service providers that are essential to the servicing of client accounts. The overall goal is to identify those tangible and intangible assets and relationships that could be compromised in an emergency.

Should the RIA's office become inaccessible or its equipment suffer permanent damage, the firm must address contingencies intended to account for such situations including the safeguarding of client-related records, the ability for the company to continue to make investments and implement investment transactions for its clients, and the ability of the company's clients to communicate with the firm. At a minimum, plans for storing, maintaining, and restoring computer data and other information should be established. However, the planning process may not stop at this point: The firm must also consider the contingency

plans established by any third party with which it has established a relationship.

No e-mail retention policy. SEC-registered advisors must maintain electronic correspondence pursuant to recordkeeping rule 204-2. State-registered advisors have to hew to similar state recordkeeping rules. As with all other correspondence and records covered by rule 204-2, electronic mail must be maintained for five years, except with respect to composite performance documentation that must be maintained for an extended period of time pursuant to rule 204-2(a)(16).


Tom Giachetti

An SEC-registered investment advisor should be prepared to produce electronic correspondence during a regulatory examination. Unless the advisor has previously implemented a written policy as to the retention and deletion of electronic correspondence prior to the regulatory examination, and follows that policy on a regular basis, the Commission will object to filtering of certain electronic correspondence in response to its request for production at the time of the examination. During a regulatory examination, the SEC will initially request electronic correspondence for a limited period of time (e.g., generally three months to one year), and may subsequently enlarge the review period based upon its findings. The electronic correspondence will include both client correspondence and internal firm correspondence. As such, an investment advisor should develop a written policy with respect to electronic mail retention and deletion.

No suitability determination policy. Although the 1940 Act does not currently impose an express suitability requirement on investment advisors, the SEC maintains that investment advisors have a fiduciary duty to reasonably determine that the investment advice or services that they provide to clients are suitable, taking into consideration a client's financial situation, investment experience, and investment objectives. Accordingly, each firm should be prepared to demonstrate to the Commission that it has a policy to obtain and maintain sufficient information regarding the client's circumstances to enable the firm to determine whether particular advice or services are suitable, initially and thereafter. Examples of the type of corresponding documents that investment advisors may determine to implement include client questionnaires, fact sheets, investment objectives confirmation letters, and/or investment policy statements.

Failure to demonstrate best execution. As fiduciaries, investment advisors are obligated to act in the best interest of their clients. Accordingly, they must seek the best available execution for each client's securities trades. The duty of best execution requires investment advisors to have their customers' orders executed at prices that are as favorable as possible under prevailing market conditions. An advisory firm will seek to meet its duty of best execution by selecting broker/dealers that can provide the best qualitative execution, taking into consideration various factors. Such factors include, but are not limited to, the value of research provided, if any, the capability of the firm to execute trades efficiently, the competitiveness of its commission rates and transaction fees, and the overall level of customer service. Thus, while the firm should give significant weight to the competitiveness of the available commission or transaction rates, it may not necessarily select the broker/dealer that offers the lowest possible rates for the firm's client account transactions. Additionally, even where the firm uses its best efforts to seek the lowest possible commission rate, it may not necessarily obtain the lowest rate for client account transactions. Depending upon the scope of the firm's trading activities, the firm can determine the availability of best execution by a variety of methods, including its own experience with transactions effected by various broker/dealers, by conducting its own surveys and soliciting data from competing broker/dealers, and by reviewing trading data from third-party industry research sources. The extent and frequency of a firm's review and monitoring

WHEN EXAMINATION DAY ARRIVES . . .

When going through a regulatory examination, RIAs should be prepared to take these steps before, during, and after the process:

✓ Conduct an entrance interview with the examiners to provide an overview of your advisory practices and operations—what you do and don't do. This will help the examiner and your firm to narrow the scope of the issues to be addressed during the examination process. Are you fee-only or do you receive commission-based compensation? Are you subject to any current complaints, litigation, or regulatory proceedings? Do you have soft-dollar arrangements, pay referral fees, publish composite performance, buy IPOs, have custody of client funds or securities, or advertise? Do clients direct brokerage, appoint you or a related person as trustee or executor, or vest you or a related person with check-writing authority?

✓ To the extent you are able, address and correct issues or deficiencies raised by the examiners prior to the conclusion of the examination, and advise them accordingly. Correspondingly, know when and how to request clarification, or to disagree or respond to issues that you believe have been misconstrued or cited in error. Speak with legal counsel at least daily to address issues raised during the examination.

✓ Request an exit interview, during which the examiners should discuss their findings with you. Take notes. The firm principal responsible for interacting with the examiners should already be aware of these issues, and, hopefully, be able to address and remedy them, or at least have begun to do so. If any of the issues cited by the examiners are of such substantial concern that they could potentially result in referral to the SEC's Enforcement Division, immediately begin to address the issue with your counsel prior to receipt of a follow-up informational request or the receipt of a deficiency letter.

✓ Respond promptly and appropriately to the issues raised in any follow-up informational requests or in the deficiency letter received from the SEC. Know when and how to disagree or respond to issues that you believe have been misconstrued or cited in error. Make sure that you take the corrective action indicated in your response letter.

procedures will depend on its business operations and trading practices.

Lack of a policy for client direction of broker/dealer selection. In the event that clients expressly direct an RIA to route all securities transactions through a particular B/D with which the firm does not have a relationship, the RIA should be prepared to demonstrate that the client made the direction (the best way is to confirm the direction in the investment advisory agreement). The RIA should also show that it has disclosed to the client in the advisory agreement and on Schedule F that he or she will be responsible for negotiating the terms and arrangements for its account with that broker/dealer and that the RIA firm will thus be unable to seek better execution services or prices from other broker/dealers or "bunch" the client's transactions for execution through the other B/Ds with orders from other accounts managed by the firm. The RIA should also show that it has disclosed to the client that he or she may incur increased commissions, transaction costs, or spreads, or receive less favorable net prices, than would otherwise be the case had the client determined to effect transactions through brokerage relationships generally available through the advisor.

In the event that transactions for client accounts are routed through a B/D that has referred the client to the firm, the potential for a conflict of interest arises and corresponding written disclosure of such relationship—in the advisory agreement and on Schedule F—must be made to the client prior to effecting transactions through the referring broker/dealer. If as result of such arrangement, the client pays more in commissions or transaction fees, the client should acknowledge, in writing (via the advisory agreement), that as a result of such direction, he shall incur higher commissions or other transaction costs than would otherwise be the case had the client determined to effect transactions through alternative brokerage relationships generally available through the advisor.

Failure to make schedule 13F filings. If an advisor has investment discretion over $100 million or more of individual equity securities traded on securities exchanges or Nasdaq, the RIA will generally be required to file quarterly reports with the SEC on Form 13F pursuant to the requirements of Section 13(f) under the Securities Exchange Act of 1934. Accordingly, the firm's chief compliance officer must monitor the firm's applicable discretionary assets under management to ensure 13(f) compliance.

Failure to comply with SEC solicitor requirements. Rules governing solicitors differ from state to state. Many, however, have indicated that individuals who refer prospective clients to an SEC-registered advisor are not subject to investment advisor or investment advisor representative registration, or any other qualification rules, such as investment-related designation or passing exams, so long as the advisor complies with rule 206(4)-3 under the Advisers Act, commonly known as the referral fee rule. Rule 206(4)-3 requires a written agreement between the advisor and solicitor setting forth certain terms and conditions of the referral arrangement. The solicitor must also provide the prospective client with a copy of the advisor's written disclosure statement at the time of the solicitation as well as a separate written disclosure document containing certain information pertaining to the solicitation arrangement, including a description of the compensation to be paid to the solicitor. The RIA must obtain, and maintain for rule 204-2 record-keeping purposes, a signed and dated document from the client acknowledging receipt of both the advisor's and the solicitor's written disclosure statements.

Web site content constitutes marketing. It should include appropriate disclosures

Misleading marketing and advertising. The SEC defines "advertising and sales literature" to include any notice, circular, letter, or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio, television, or Internet that offers any report, analysis, graph, chart, or formula concerning securities or to be used in determining what securities to buy or sell, or any other investment advisory service with regard to securities. Detailed rules under the Act govern the use of advertising and sales literature by the advisory firm. The SEC will generally base its determination on whether an advertisement is "misleading" on all the particular facts relative to the advertisement, and would look carefully at the form and content of the advertisement, the implications or inferences that could reasonably be made from the advertisement in its total context, and the overall sophistication of the audience who was receiving the advertisement's message. The SEC objects to the use of superlatives in marketing materials, brochures, and Web sites. These qualifiers, such as state-of-the-art, outstanding, superior, or world-leading, are usually unnecessary and should be minimized or eliminated.

In addition, the use of performance data in advertising and marketing materials is a highly complex subject and is carefully scrutinized by the SEC. The reason for the complexity of this subject is that the SEC has not established any fixed formulas for the calculation of investment advisor performance. In recent years, however, the SEC has provided guidance to advisors on its requirements for performance advertising. Therefore, particular care must be taken to ensure that materials presenting the composite performance of firm accounts meet SEC rules and interpretations and contain required disclaimers and legends. Finally, the contents of an advisor's Web site constitute advertising and marketing materials. Advisors that maintain a Web site should include appropriate disclosures to make sure its content is not misleading. Additional substantive Web site disclosures should be included, depending upon specific content and links to third-party sites. IA

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