

Second “ComplianceAlert” Cites Common Deficiencies, Effective Practices of Advisers, Funds and Brokers

The staff of the Office of Compliance Inspections and Examinations of the Securities and Exchange Commission (“SEC”) published its second ComplianceAlert to advise chief compliance officers of common deficiencies and weaknesses, as well as certain effective practices found by SEC examiners during compliance inspections of investment advisers, investment companies, broker-dealers and other regulated entities. One purpose of the Alert is to encourage improvement in compliance and compliance programs.

Summarized below are common compliance issues found and effective compliance practices observed by the SEC examiners during recent examinations as described in the current ComplianceAlert.

Investment Advisers/Mutual Funds

Personal Trading by Advisory Staff

In examinations related to employee trading and trading by an advisory firm for its proprietary accounts, the SEC examiners identified deficiencies in the following areas:

- failure by an adviser to address in its code of ethics certain regulatory requirements, such as insufficient pre-approval requirements;
- failure to follow the adviser’s written code of ethics;
- failure by employees to provide or to provide in a timely manner reports of their personal securities transactions and failure by advisers to review those reports; and
- failure to disclose accurately in the adviser’s brochure controls over personal trading.

The SEC staff noted various practices that appeared to be effective in preventing the foregoing deficiencies. In particular, advisory firms whose compliance personnel were “actively involved in implementing those programs” and ensured that employees were aware of, and received training in, the advisers’ policies and procedures generally had effective compliance programs. Firms that required employees to acknowledge, in writing, each year that they had read the adviser’s code of ethics also generally had effective compliance programs.

Proxy Voting and Fund’s Use of Proxy Voting Services

The SEC examiners found that “most” advisory firms had adopted the required proxy voting policies and procedures. However, the following deficiencies, among others, were found:

- weak board oversight by mutual funds using third-party proxy services;
- failure by advisers to document their assessment of third-party proxy services regarding conflicts of interest and independence;
- failure to vote consistently with proxy voting policies; and

- improper allocation of fees of third-party proxy services to funds that did not hold the securities that required such services, or failure to disclose that soft dollars were used to pay for such services.

The SEC staff noted that firms generally had effective processes in place to identify proxy voting conflicts of interest.

Valuation and Liquidity Issues in High Yield Municipal Bond Funds

The SEC staff examined high yield municipal bond funds that invest in securities that trade infrequently or not at all in the secondary market. In such situations, market quotations are not readily available and fund boards determine the fair market value of their instruments for net asset value purposes using third-party pricing services.

These examinations resulted in the following observations:

- high yield funds with higher average credit qualities, fewer unrated securities and fewer distressed and defaulted securities were less likely to have valuation and liquidity issues;
- high yield funds “often” did not disclose that when the percentage of illiquid securities held by the fund increased, there was an increased risk to valuation and liquidity;
- disclosures that a fund uses pricing serves to provide “independent” values “may” be misleading when pricing services relied on fund management to provide it with information needed to value securities;
- cross-trades among client accounts can create risks that securities will be “dumped” from one client account to another or mispriced;
- “some” funds did not adequately assess the accuracy of prices provided by pricing services; and
- electronic records allow for more efficient analysis.

Soft Dollars Practices of Investment Advisers

The SEC staff examinations of soft dollar arrangements of advisers revealed that research and trade execution assistance products (products within the Section 28(e) safe harbor) were the most common services/products received. “All” the advisers examined told examiners that they had “informal commission targets” with the broker-dealers providing the research services and that these targets were intended as guides, not firm commitments. (Commissions on transactions that earned soft dollar credits ranged from \$0.01 to \$0.08 per share, with an unweighted average commission rate on soft dollar trades of \$0.05 per share.) The staff noted that “most” advisers documented their efforts to seek best execution and conducted periodic execution quality reviews. In the “few” instances where advisers accumulated large soft dollar credit balances at broker-dealers, the SEC examiners analyzed whether the commissions paid were reasonable. The staff also noted that “most” advisers disclosed the types of products, research and services received in exchange for soft dollars and complied with disclosure requirements regarding conflicts of interest related to soft dollars. However, examiners also found instances where advisers did not disclose to clients that they acquired products and services outside the Section 28(e) safe harbor.

Broker-Dealers

Examinations of Securities Firms Providing “Free Lunch” Sales Seminars

The Financial Industry Regulatory Authority (“FINRA”), the North American Securities Administrators Association (“NASAA”) and the SEC examined broker-dealers, investment advisers and other financial services firms that offer “free lunch” sales seminars. The examiners observed that seniors are “often” the target attendees and are offered attractive inducements to attend, such as free meals, door prizes and vacations. They also observed that these seminars are actually designed to sell investment products, although they are advertised as simply “educational” or as “workshops.” The examiners noted that effective supervisory control includes a requirement that employees forward sales material for review prior to their use. The examiners found that “half” the firms used misleading or exaggerated sales material, and that “many” broker-dealers did not submit them to FINRA for review. The examiners also found that the attendees may not have understood that the seminar sponsor or particular speaker at the seminar had a financial interest in a particular product being recommended.

Examiners discovered that firms sponsoring “free lunch” seminars had weak supervisory practices for these seminars and were recommending unsuitable investments for the targeted customers. They also disclosed that possible fraud may have been involved as a result of “serious” misrepresentations. The examiners urged firms to supervise sales seminars more closely and to ensure that investment recommendations to seniors are suitable.

Valuation and Collateral Management Processes

SEC examiners coordinated with FINRA and examined valuation and collateral management practices of select large broker-dealers as they relate to subprime mortgage-related products. Examiners observed that, due to a lack of market liquidity, firms had difficulty in independently verifying their inventory valuations, and, as a result, relied on modeled prices or more broadly observable market information available with respect to derivative markets. The examiners noted deficiencies in this area, including price verification deficiencies, insufficient staffing, inadequate and inconsistent documentation standards, inadequate valuations of collateral, inconsistent pricing and failure to adequately establish processes surrounding the issuance and resolution of margin calls on collateral.

SEC examiners noted several strong control practices in this area, including:

- establishing policies with respect to valuation that contemplate the possibility of illiquid markets, which, in turn, necessitate alternative pricing methodologies;
- experienced and knowledgeable staff;
- established standards to support valuation and documentation of same, including difficult-to-value positions in periodic month-end reviews;
- an internal repository for security position information to ensure consistency; and
- price verification, collateral management and margin call processes and procedures that are adequately documented.

Broker-Dealers Affiliated with Insurance Companies

Examiners conducted targeted reviews of a number of broker-dealer subsidiaries of insurance companies and noted instances of unsuitable recommendations, inadequate supervisory procedures and deficiencies in compliance with financial responsibility requirements. Examiners noted that “many” of these deficiencies were due to a lack of controls and the fact that these broker-dealer firms were managed by individuals whose primary experience was in the insurance industry and lacked knowledge of the securities industry.

Supervision of Solicitations of Advisory Services

Examiners conducted targeted examinations of broker-dealers that designated their registered representations as “solicitors” for an investment adviser. The examiners noted that the solicitors were improperly providing investment advice to customers (that is, they were not merely acting as “salesmen” to potential clients of the adviser). The examiners noted a lack of supervision with respect to the suitability of advisory services and investments recommended by the solicitors and a failure to establish or enforce adequate written supervisory procedures for the solicitors. In addition, some of the broker-dealers used false advertising and/or misleading sales literature and failed to file these sales material with FINRA or to have a principal indicate review and approve of the material.

Mortgage Financing as Credit for the Purchase of Securities

Examiners conducted risk-targeted examinations of broker-dealers that recommended that customers finance the purchase of securities with a second or reverse mortgage on their homes from a bank affiliated with the broker-dealer. Examiners noted that many firms prohibit registered representatives from recommending that their customers obtain loans (other than margin) to purchase securities. However, examiners found that in those instances where firms allowed registered representatives to refer customers to an affiliated bank for a mortgage, the supervision and recordkeeping relating to these activities was “poor.” Further, they noted heightened concerns with respect to the suitability of recommendations to mortgage a home to finance the purchase of securities.

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The SEC staff encouraged chief compliance officers to review compliance areas summarized in the ComplianceAlert, address any compliance or supervisory weaknesses in their firms’ existing policies and procedures, and implement improvements, as necessary.

The SEC ComplianceAlert is available at <http://www.sec.gov/about/offices/ocie/complialerto7o8htm>.

For Additional Information

If you have any questions about SEC compliance examinations, the effectiveness of your compliance program or how to implement changes to your program, please contact one of the Katten Muchin Rosenman LLP attorneys listed below.

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