



## Legal Risk Management Tip October 2009

### The Evolving World of Compliance

For those of you who were fortunate enough to attend the National Society of Compliance Professionals' National Meeting from October 5 - 7, 2009, you may have noticed there was a feeling of urgency for evolution, enhancements and change. This was perhaps most noticeable when John Walsh, current Active Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE") announced at the opening of his key note address, "the compliance world has changed forever" - and the room fell silent.

As Mr. Walsh stated, it is the compliance professional's job to remind persons of lessons learned within the past six-months post-Madoff. In this month's Risk Management Tip, JLG wishes to share with you some of these lessons as presented and spoken about earlier this month at the NSCP Meeting.

#### 1. Changes in the Compliance World

The SEC Examination program is in a state of evolution. The US Attorney General is providing the SEC with various ideas on how to improve its examination program. As part of this, "Change Agents" are being appointed within the SEC to study on ways to enhance OCIE. The following observations have been recently made.

- a. The SEC needs more expertise to keep up with the businesses it oversees. To this extent, OCIE is developing a team of Senior Specialized Examiners ("SSE") to focus on a particular niche area of expertise, such as options.
- b. The SEC is enhancing its examinations by requiring a "certified fraud credential" for all examiners. As part of this scope, the SEC shall work with other agencies to conduct "independent verification of third-parties."

Through use of these enhancements, the SEC may be able to better ensure that its examiners are being deployed effectively and efficiently to address a particular problem in a corroborate fashion. To accomplish this, cross-training will occur across focus disciplinary areas across differing regulatory bodies on subjects such as algorithmic trading.

For those securities firms that are being examined, consider yourself put on notice - the SEC staff will not be intimidated. OCIE has established an internal hotline for examiners to call if the staff is being threatened during an examination. If there is a problem during the examination process, those firms are encouraged to speak with the examiners' supervisor (rather than become irate to the SEC staff).

In addition, the SEC is conducting its own "Annual Review" to identify its gaps and risk areas. Just as investment companies, investment advisers and FINRA member broker-dealers must conduct an annual review, so now is the SEC.

## **2. Current Investment Adviser Hot Buttons**

The following highlights those current "hot buttons" for registered investment advisers as identified by the SEC staff during the conference.

Detecting Fraud to Protect Investors – The SEC intends to focus on misappropriation of funds. Specifically, the SEC will enquire as to whether the assets are there, do clients own what they think they own, and whom is custodial assets.

Valuation – The Commission will be looking at whether assets exist or have they been "over valued." To that extent, expect heavy focus on firm valuation policies.

Marketing and Performance Claims – Currently, the SEC is reviewing policies and procedures for the firm's adherence to books and records requirements for storing electronic marketing materials and sign-off from Compliance. Some recent examination findings include: unsupported claims use of superlatives non-adherence to Regulation D requirements; non-compliance with GIPS® standard; and inadequacy of disclosures.

Suitability – The SEC is reviewing new client account relations and is looking at how the adviser concluded the investment was suitable. Importantly, the SEC is looking at the disclosures made at the time of the recommendation, and then checking on what the adviser has done in conjunction with client expectations. To that extent, advisers should remember to: (1) document investment objectives and risk tolerance; (2) allocate products appropriately (e.g. – hot issues to high net-worth clients); and (3) be able to speak to risk tolerances desired by clients and document accordingly.

Financial Solvency – this is a top priority due to risks as a result of financial crisis. To this extent, the SEC is inspecting (1) regulatory filings; (2) presentations and disclosures made to the public; and (3) reviewing incentive programs and what is being paid.

Market Manipulation and Insider Trading – Among other things, the Commission may review the "top trades" to test if insider trading is occurring. Expect the Commission to review e-mails to see what contributed to the trade's success as well as trend analysis and performance attribution reports, research files from the portfolio management team and supporting documentation of where research came from (and not just "my good buddy" provided this to me).

Disclosures / Written Notices to Clients – During recent examinations, the SEC staff is finding that disclosures to clients are often missing important information relating to conflicts of interest. This may include, among other things, information relating to side-by-side management arrangements, directed brokerage, side letters, and asset allocations. In addition, the Commission is aware of an increase in the number of hedge fund investor complaints which allege that the general partners did not appropriately accept

subscription documents, and includes demands for reimbursement of funds. As a result, many General Partners are electing to redeem shares, but if only some clients are getting that offer (and not all), that shows unfair favoritism which could trigger the anti-fraud provisions of federal securities laws.

### **3. Current Broker-Dealer Hot Buttons**

With respect to the broker-dealer world, some common themes were emphasized by the regulators, namely the use of specialized examiners and third party verification, as mentioned above, as well as the use of the hotline for situational problems with examinees. However, some additional points were emphasized as well.

Jurisdiction – In the post-Madoff world, FINRA is seeking to extend its reach broadly in spite of potential concerns with respect to jurisdiction. As in Madoff, FINRA has found its reach limited from time-to-time because the jurisdiction over a particular entity or matter may reside with the SEC. Going forward, FINRA’s representatives will more aggressively seek voluntary cooperation with respect to document production even when it may not necessarily have jurisdiction. Notably, while an examinee may refuse a request that it believes to be outside the scope of the examinee’s authority, FINRA’s next step may be simply to go to the SEC and ask them to require production.

Protecting Accredited Investors – In the current environment, FINRA is particularly concerned about whether individuals are appropriately invested even though they meet the current definition of accredited investor. Pursuant to Rule 501(a) of Regulation D of the 1933 Act, an individual must have an individual net worth or joint net worth with their spouse in excess of \$1,000,000. FINRA’s concern is that this definition does not necessarily capture investment knowledge because a high net worth does not necessarily equal sophistication.

As a result, FINRA will look carefully even where investors meet this requirement to examine each product and its underpinnings. Their goal will be to ensure that both the broker-dealer understands the suitability requirements for the product and that the investor understands what he/she has purchased. Some areas that FINRA will examine include: disclosures, any conflicts of interest, and the fee structure. Further, for a product that is particularly complex, FINRA will seek to dive deeper into the broker-dealer’s training materials, sales materials, and the process that the firm uses to select new products. Don’t be surprised if during an examination FINRA tries to confirm that compliance, sales and the trading desk both understand and comprehend the product and its associated risks.

Additional Examination Focus Points – Finally, FINRA will be watching a few generalized areas when conducting its examinations in the coming year. These may include:

- Reviewing a firm’s process and documentation with respect to outside business activities;

- Considering whether representatives are appropriately contacting their customers with respect to confirming decisions;
- Direct market access (small broker dealers);
- New products and whether firms are simply restructuring old, toxic products for resale;
- Appropriateness of disclosures;
- Identify theft; and
- Social networking sites.

#### **4. Final Thoughts**

During this fourth quarter, firms shall be meeting with Senior Management to plan budgets for next year and to develop project calendars for strategic initiatives. In preparation for attending these meetings, you may wish to review this Risk Management Tip to ascertain:

- What haven't we done yet that should be before year-end (e.g., due diligence on third-party service providers)
- Does the firm's associated persons have training on how to detect (and prevent) fraud to investors
- Have we identified the firm's high risk areas in 2009 and planned how to address those risks in the near term
- Do our disclosures and notices to our clients require modification
- How does the firm's risk management program compare to others with a similar business model and size

Should you have questions or require additional assistance, please do not hesitate to contact us at (619) 298-2880.

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