



CCOutreach

2007 Regional Seminars

This document is intended to provide investment company and investment adviser Chief Compliance Officers with factors or controls to consider when evaluating the effectiveness of their firms' compliance programs. It provides information regarding documents and information examiners request, analyses examiners perform, and common deficiencies found on examinations for the following areas:

- *Disclosures and Filings and Books and Records*
- *Portfolio Management*
- *Performance Advertising and Marketing*
- *Brokerage Arrangements and Execution, Trade Allocation, and Soft Dollars*

The forensic measures discussed in this document are not an exhaustive list. Rather, such measures are examples of tests, some of which are already widely used by both registrants and examiners.

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Disclosures and Filings and Books and Records

A. Documents and Information Examiners Frequently Request and Analyses Frequently Performed

1. Information Disclosures, Reporting, and Filings

- **Form ADV Parts IA and II and any alternative written disclosure statement used in lieu of Part II.**
 - ✓ Determine whether annual and/or updating amendments were filed in a timely manner.
 - ✓ Review Form ADV for omissions and/or misleading information.
 - ✓ Determine whether any alternative brochure used contains at least the same information required by Form ADV Part II.
- **Wrap fee brochure prepared in response to Schedule H of Form ADV.**
 - ✓ Review for material omissions and/or misleading information.
- **Copies of any internally generated position or performance statements provided to clients.**
 - ✓ Compare internally generated statements to records from third-parties (e.g., custodian or broker) to ensure accuracy of reported information.
 - ✓ Review performance statements for omissions and/or misleading information.
- **Fund prospectuses, statements of additional information, and annual and semi-annual reports, and pooled investment vehicle offering documents.**
 - ✓ Review offering documents, prospectuses, and statements of additional information for completeness and to identify any omissions and/or misleading information.
 - ✓ Determine whether annual and semi-annual reports were filed in a timely manner.

- **Disclosure controls and procedures required by Rule 30a-3 of the Company Act and concerning the certification and filing of Forms N-CSR.**

- ✓ Review controls and procedures to determine effectiveness.

2. *Books and Records*

- **Advisory, sub-advisory, administration, distribution, and custodial agreements entered into by the firm.**

- ✓ Determine whether payments are made in accordance with the terms of all agreements.

- ✓ Review contracts for both required and prohibited provisions.

- **Documentation of annual offer of Form ADV Part II.**

- ✓ Determine whether Form ADV is offered or delivered annually.

- ✓ Ensure that the firm maintains a copy of each statement given or sent to any client and a record of each offering.

- **Memorandum of each order given by the firm for the purchase or sale of any security.**

- ✓ Ensure that the firm maintains order memoranda and determine whether the order memoranda contain all required information.

- **Access persons' initial and current annual holdings reports and quarterly transaction reports.**

- ✓ Review reports to determine whether they contain all required information.

- ✓ Determine what reviews, if any, the firm conducts based on the information contained in the reports.

B. Common Deficiencies

1. *Information Disclosures, Reporting, and Filings*

- **Inaccurate or incomplete disclosures**

Examples:

- Firms did not disclose all material conflicts of interest that surround and influence their businesses.

- Firms did not adequately disclose all industry activities and affiliations.
- Firms did not adequately describe their codes of ethics.
- Wrap fee brochures did not include all material facts about the wrap fee program.
- Fund prospectuses and statements of additional information contained inaccurate or misleading information.

- **Delivery of disclosures to clients**

Examples:

- Firms did not provide written disclosure statements to new and prospective advisory clients within the required time frame.
- Firms did not provide or offer written disclosure statements to existing clients at least annually.

- **Timeliness of filings**

Example:

- Firms did not file annual amendments to Form ADV within 90 days of their fiscal year end.

2. *Books and Records*

- **Completeness**

Example:

- Firms did not record all financial transactions, indicating that they may not have adequate accounting controls in place.
- Firms did not maintain all supporting records for performance from previous employment.

- **Accuracy**

Examples:

- Firms' books and records were not true and accurate.

- Firms' financial statements did not reconcile to source documents and bank statements.
- Internally-generated client statements did not reconcile to third-party statements.

- **Accessibility**

Examples:

- Firms' books and records were not organized or were not easily accessible.
- Firms maintained records on an informal basis, indicating that they may not have adequate controls in place.
- Firms stored records electronically, but did not arrange or index the records to permit easy location, access, and retrieval.

- **Maintenance**

Examples:

- Firms' books and records were not preserved for the correct length of time or were not stored in an appropriate location.
- Firms' records supporting performance advertising calculations were not kept for five years from the end of the fiscal year in which they were last published or disseminated.
- Firms' codes of ethics and compliance procedure records did not include all policies that had been in effect within the past five years.

- **Safety**

Examples:

- Firms stored records electronically, but did not have procedures to reasonably safeguard the records from loss, alteration, or destruction.
- Firms did not limit access to records to properly authorized personnel.

C. Controls to Consider

1. *Information Disclosures, Reporting, and Filings*

- Create a compliance calendar to ensure that all filings and updates are made or provided to clients in a timely manner.

2. *Books and Records*

- Periodically sample performance records and order memoranda to ensure that they are maintained properly.
- Periodically review all contracts to ensure that the terms are current and that fee schedules are accurate.
- Periodically test the disaster recovery plan.

Portfolio Management

A. Documents and Information Examiners Frequently Request and Analyses Frequently Performed

- **Firm's trading blotter or purchase and sales journal, including the transactions of the firm's access persons and proprietary accounts.**
 - ✓ Review trading activity to determine whether investments are in line with client objectives.
 - ✓ Determine if block trades were allocated using average price and consistent commission rates within the block.
 - ✓ Determine whether any principal and/or cross trades have been conducted. Verify that appropriate disclosures have been given and client consent obtained. Verify prices at which such trades were conducted and commissions charged. Cross trades could also be conducted in an effort to “dump” securities on certain clients to benefit other clients.
 - ✓ Review end of quarter/end of year trading for any evidence of “window dressing.”
 - ✓ Calculate portfolio turnover for a sample of client accounts. Compare the turnover to the stated investment objective to look for disparities.
 - ✓ Review proprietary and access person accounts for possible frontrunning and/or personal securities policies and procedures violations as well as execution prices and commission rates that are more favorable than those for client accounts.
- **Performance returns for each client account for a specified period.**
 - ✓ Compare performance among accounts and composites to look for performance disparities for indications of favoritism or inequitable allocations.
 - ✓ Compare performance of personal, related, or proprietary accounts versus the performance achieved by clients for indications of favoritism toward insiders.
 - ✓ Calculate and compare the percentage of profitable trades in client accounts and personal, related, or proprietary accounts.

- **Firm’s records pertaining to each client account, including advisory agreement, correspondence, fee invoices, custodial statements, internally generated statements, etc.**
 - ✓ Review documentation of client objectives and restrictions. Compare these with portfolio holdings and transactions.
 - ✓ Review fees for accuracy and consistency with advisory agreement and disclosures.
 - ✓ Compare third-party custodial statements to firm’s internally generated statements and review trade and billing errors.
 - ✓ Evaluate controls used to ensure compliance with disclosures made to clients regarding portfolio management activities.
- **A list of publicly traded companies of which any officers, directors or affiliates of the firm serve as officers or directors.**
 - ✓ Determine whether the firm places its own interests above those of clients in making investment decisions.
 - ✓ Determine whether conflicts of interest are properly disclosed to clients.
- **A list of any sub-advisory arrangements the firm has with other investment advisers or money managers.**
 - ✓ Review due diligence the firm conducts on sub-advisers to ensure that client accounts are managed in accordance with their objectives.

B. Common Deficiencies

- **Misleading or incomplete disclosures**

Examples:

- Firms did not disclose all conflicts of interest which impact their investment decision making abilities.
- Firms did not make required disclosures regarding voting of client proxies.
- Firms did not disclose to clients invested in securities such as variable insurance products and mutual funds that they are paying several layers of investment advisory fees.

- **Inadequate policies and procedures**

Examples:

- Firms did not have effective policies and procedures in place to ensure that portfolios are managed according to client objectives and restrictions.
- Firms did not establish effective policies and procedures to control and monitor conflicts of interest which impact investment decision making abilities.
- Firms did not effectively review portfolio management by sub-advisers to ensure that client assets are managed in accordance with their objectives.
- Firms did not have sufficient controls in place to ensure the accurate deduction of advisory fees from client accounts.
- Firms did not review the suitability of wrap fee programs for clients.

C. Controls to Consider

- Regularly communicate with clients regarding their objectives, document communications and resulting changes, and compare objectives to trading activity.
- Systematically review client accounts to ensure that all investments and associated risks are suitable for the client.
- Periodically conduct performance comparisons of accounts with like objectives to determine consistency of portfolio management.
- Regularly generate cash holdings reports to identify any large or unnecessary cash balances.
- Engage multiple independent pricing services to value the same portfolio on a systematic basis.

Performance Advertising and Marketing

A. Documents and Information Examiners Frequently Request and Analyses Frequently Performed

- **The specific compliance policies and procedures that govern marketing and performance advertising.**
 - ✓ Determine whether the firm has established internal controls to ensure the accurate calculation of performance and the use of such information in ways that are not misleading.
 - ✓ Determine whether the firm has established internal controls to ensure that marketing and distribution activities are consistent with regulatory requirements and disclosures.
- **Copies of advertisements, promotional brochures, pamphlets and other materials, including composite or representative reports and data, used to inform or solicit clients or shareholders.**
 - ✓ Review materials for specific prohibitions outlined in Rule 206(4)-1 including: testimonials, past specific recommendations, and false or misleading statements.
 - ✓ Determine whether fund sales literature includes all information required by Rule 34b-1.
 - ✓ Determine the accuracy and adequacy of disclosures made in such materials.
 - ✓ Review claims of compliance with Global Investment Performance Standards for accuracy.
- **Copies of recently completed RFPs (Requests-for-Proposals) and third-party consultant questionnaires.**
 - ✓ Review responses for accuracy and ensure disclosures are adequate and consistent with the firm's other performance and advertising materials.

- **Account inclusion criteria the firm employs in the construction of any composite performance results.**
 - ✓ Determine whether the firm has developed written criteria that fully describe how composites are created and maintained and the methods and authorizations necessary to make changes.
 - ✓ Review all accounts to determine whether the firm's inclusion criteria are consistently and reasonably applied.
- **Records substantiating advertised performance.**
 - ✓ Compare internal calculations indicating asset values, capital additions and withdrawals, and periodic performance returns with corresponding custodial statements.

B. Common Deficiencies

- **Omitted or misleading disclosures**

Examples:

- Firms did not include the disclosures necessary to prevent their advertising from being misleading.
- Firms did not reflect the deduction of advisory fees in performance numbers.
- Firms did not disclose whether and to what extent the results portrayed the reinvestment of dividends and other earnings.
- Firms did not disclose all material facts relevant to a comparison of performance results to an index.

- **Inaccurate returns**

Examples:

- Advertised returns differed from actual returns calculated by the firm.
- The review and approval process for marketing materials is flawed and inaccuracies are not noted.
- Potential clients or shareholders were materially misled by inflated performance materials.

- **Inappropriate advertising of past specific recommendations**

Examples:

- Firms inappropriately provided examples of investment recommendations made during prior periods, and the performance generated from these investments, in presentations to clients.
- Firms inappropriately included examples of past recommendations and their profitability in their marketing materials.

- **Inaccurate claims of performance calculations in compliance with GIPS**

Examples:

- Firms claimed that they calculated performance in a manner that was consistent with *GIPS*, but were not in compliance with all of the *GIPS* requirements.
- Firms did not document their policies and procedures used in establishing and maintaining compliance with all the applicable requirements of *GIPS*.

- **Inadequate policies and procedures**

Examples:

- Firms lacked sufficient policies and procedures addressing marketing and performance advertising.
- Policies and procedures did not ensure that third-party consultants received accurate presentations.
- Policies and procedures were not adequate to ensure that the firms were in compliance with all applicable requirements of *GIPS* prior to making a claim of such compliance.
- Policies and procedures did not require a consistent comparison of composites to appropriate benchmarks.
- Policies and procedures did not ensure accurate composite descriptions.

C. Controls to Consider

- Ensure that a compliance person reviews marketing materials and that only those materials reviewed and approved by compliance are used.
- Regularly compare all composite accounts to their respective benchmarks to ensure proper composite construction and maintenance.
- Limit employee access to performance data.
- Perform periodic sampling and random sampling of the performance information to ensure the integrity of the data.
- Review and update performance policies and procedures to accurately reflect firm practices.

Brokerage Arrangements and Execution, Trade Allocation, and Soft Dollars

A. Documents and Information Examiners Frequently Request and Analyses Frequently Performed

1. *Brokerage Arrangements and Execution*

- **A list of affiliated broker-dealers featuring their affiliation and a description of their clearing arrangements.**
 - ✓ Review the total brokerage allocated to the affiliated broker. Determine whether the use of the affiliated broker is adequately disclosed.
 - ✓ Determine whether the brokerage and execution quality received by the affiliated broker is periodically and systematically reviewed; compare to other brokers to determine the appropriateness of the continued use of the affiliate.
- **A list of broker-dealers with whom the firm has or had revenue sharing agreements for any purpose during the review period.**
 - ✓ Compare the brokerage and execution quality received by such brokers versus other brokers used by the firm.
- **A copy of brokerage allocation reports for a specified period, featuring the name of the broker, aggregate amount of agency commissions by the broker, and aggregate principal values or imputed compensation for principal transactions by the firm.**
 - ✓ Compare the total brokerage amounts allocated to each broker. High allocations of trades could indicate a significant relationship with a particular broker.
 - ✓ If a brokerage budget is prepared, compare total brokerage to this budget. Determine why certain brokers were used more or less than the brokerage target.
- **Procedures adopted pursuant to Rules 10f-3, 17a-7, 17e-1, 12b-1(h), and 12d3-1, and documentation of transactions effected pursuant to these procedures.**
 - ✓ Determine whether such transactions were in accordance with fund objectives.
 - ✓ Ensure that transactions were appropriately reported to and approved by the Board of Directors or Trustees.

2. Trade Allocations

- **A list of all initial public offerings in which clients (including registered and unregistered funds), proprietary accounts, or access persons participated (i.e., purchased shares).**
 - ✓ Determine which clients received shares of the IPO allocation and whether the IPOs were consistent with client investment objectives.
 - ✓ Determine whether certain accounts (e.g., accounts paying an incentive fee) may have been favored.
 - ✓ Determine if proprietary or access person accounts received IPO allocations and whether these allocations were consistent with the firm's disclosures and code of ethics.
 - ✓ Review the net gain or loss on IPOs and determine whether any accounts appeared to receive an inordinate number of "hot" IPOs.
- **Performance returns for each client account for a specified period.**
 - ✓ Compare the performance of accounts with similar objectives to determine if investment opportunities were allocated consistently.
- **A list of shareholders owning 1% or more of Fund shares.**
 - ✓ Review the allocation of investment opportunities among funds and clients to determine if funds substantially owned by insiders received more favorable allocations.

3. Soft Dollars

- **For all soft dollar arrangements, a detailed description of how the product or service is used by the firm.**
 - ✓ Determine to what extent the products or services obtained with soft dollars are research related.
 - ✓ Ascertain whether all or only a select group of clients benefits from the product or service.
 - ✓ Compare the value of the product or service to the level of commissions paid for the product or service.

- **Indicate whether the products or services received by advisers to registered investment companies pursuant to soft dollar arrangements are within the safe harbor provided in Section 28(e) of the Securities Exchange Act of 1934.** (Note: Advisers to registered investment companies may violate Section 17(e) of the Investment Company Act of 1940 if they receive products or services pursuant to soft dollar arrangements outside the safe harbor provisions of Section 28(e).)
 - ✓ If commissions are used to pay for non-research items (i.e., products and services that fall outside the safe harbor), determine whether this is adequately disclosed.
 - ✓ Determine whether any violations of Section 17(e) of the Company Act occurred.
- **Allocation procedures for mixed-use items.**
 - ✓ If a product or service is deemed of mixed-use, determine the appropriateness of the allocation between hard and soft dollars.
- **Provide the approximate annual amount of commissions on securities transactions needed to satisfy each soft dollar arrangement.**
 - ✓ Review the firm's periodic and systematic evaluations of brokerage firms used. Determine whether soft dollar brokers are deemed to provide good execution.
 - ✓ Ascertain whether the firm appears to be forgoing best execution in order to satisfy its soft dollar commitments.
 - ✓ Compare the current level of brokerage sent to the soft dollar brokers to the amount needed to satisfy the commitment.

B. Common Deficiencies

1. *Brokerage Arrangements and Execution*

- **Inaccurate disclosures**

Examples:

- Firms did not disclose all material conflicts of interest that surround and influence their brokerage arrangements.
- Firms' trading practices were inconsistent with disclosures to clients.

- Firms accepted client directed brokerage accounts without disclosing the effect on their ability to attain best execution for such clients.
- Firms directed trades to affiliated broker-dealers and did not disclose such practices to clients.
- Firms directed cross trades between advisory clients without disclosing such practices to clients.

- **Inadequate policies and procedures**

Examples:

- Firms did not have adequate policies and procedures governing their brokerage arrangements and execution.
- Firms did not periodically and systematically review execution.
- Firms did not document their evaluation to substantiate that they acted in a manner consistent with their fiduciary duty to clients.

- **Compensation for sale of fund shares**

Example:

- Trades were allocated to compensate brokers for their efforts in selling fund shares.

2. Trade Allocations

- **Inadequate policies and procedures**

Examples:

- Firms lacked sufficient policies and procedures to adequately address their trade allocation practices.
- Firms did not implement adequate monitoring and testing procedures to ensure that trade allocations were fair and did not favor or discriminate against any client or account.
- Firms did not follow their allocation policies and procedures consistently and frequently departed from their initial allocation decisions for inappropriate reasons.
- Firms did not document their allocation decisions and reviews.

- **Inappropriate trade allocations**

Examples:

- Certain accounts received preference over others in receiving the most desirable investment opportunities at time of purchase.
- Securities were sold out of favored accounts first to obtain superior prices or secure limited selling opportunities.
- Wrap fee, directed brokerage, and sub-advised accounts were consistently placed at the end of the order-entry queue.
- Profitable trades were allocated to proprietary or favored accounts.

3. *Soft Dollars*

- **Insufficient internal controls**

Examples:

- Firms did not have policies and procedures in place to account for and monitor the amount of soft dollar credits, including allocations made to mixed-use items.
- Firms did not make a good faith determination for the value of research received with soft dollars.
- The receipt and use of soft dollar credits was not documented.

- **Inappropriate use of soft dollars**

Examples:

- Firms' use of soft dollars did not correspond to disclosures to clients.
- Firms did not disclose that they received products and services pursuant to soft dollar arrangements which fall outside the safe harbor provisions of Section 28(e).
- Non-research costs of mixed-use items received pursuant to soft dollar arrangements were not appropriately allocated and were contrary to disclosures provided to clients.

C. Controls to Consider

1. *Brokerage Arrangements and Execution*

- Formalize a process to regularly monitor and evaluate broker performance and execution quality

2. *Trade Allocations*

- Regularly compare the performance of like accounts and research outliers. Document these results.

3. *Soft Dollars*

- Track the use of items deemed of mixed-use and allocation of their cost between hard and soft dollars based on actual usage.