

The Securities and Exchange Commission (SEC) conducts periodic routine audits of investment advisers. Frequently, SEC staff discuss these examinations and provide helpful guidance to investment advisers. That happened recently in a speech given in March 2007 by Lori Richards, the SEC's Director of Office of Compliance Inspections and Examinations. Let's review the guidance that she provides. Let's also highlight why the new compliance rules, especially those regarding risk identification and mitigation, present challenges for investment advisers...

SEC Details Deficiencies Most Commonly Found During Examinations Of Investment Advisers



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Preliminarily, Ms. Richards revealed that, in 2006, the SEC conducted 1,300 examinations of investment advisers. 81% of those examinations found deficiencies, identifying problems and asking for corrective action. According to Ms. Richards, the "vast majority" of advisory firms take corrective

action. However, in about 6% of the examinations, the SEC finds "indications of very serious violations - mostly fraud of some type." The SEC refers those cases to its enforcement staff for further investigation. Ms. Richards shared with her audience the five most common deficiencies that the SEC had found during its examinations conducted in 2006:

- 1) Deficiencies in information disclosure, reporting and filings.** This category includes documents being untimely filed, inaccurate and incomplete, and relates to conflicts of interest, compensation arrangements, solicitation arrangements, fee structures and brokerage/soft dollar arrangements.
- 2) Deficiencies regarding the personal trading by advisory firm personnel.** This category covers an adviser's failure to report or review trading by personnel, as well as improper allocations of securities to accounts.
- 3) Problems in performance advertising and marketing.** Advisers have failed to disclose relevant information, causing the advertisement to be misleading. Additionally, advisers have not accurately reported their performance in advertisements.
- 4) Problems in information processing and the protection of customer information.** The SEC has noted "weaknesses" in business continuity plans, Regulation S-P procedures, and the creation and compilation of certain books and records.
- 5) Deficiencies regarding the new compliance rules.** The SEC has found, for example, that "firms' compliance manuals did not address firms' risks, listed risks that did not exist at firms, or established procedures that firms did not follow." Let's further explore that common deficiency, as the new compliance rules present challenges for investment advisers.

From materials that our investment adviser clients share with us in connection with their SEC examinations, we know that the SEC is serious about enforcing an effective "compliance culture" at investment advisory firms. That means that investment advisers who purchase "off the shelf" compliance materials and fail to customize them to the needs of their firms - likely much of what the fifth common deficiency noted above concerns - will not pass muster. The SEC cautions that "procedures and compliance manuals represent a useful starting point; these manuals do not, however, provide information about how compliance policies and procedures are being applied in practice or how effective such policies and procedures may be in preventing, detecting and correcting compliance problems."

Indeed, investment advisers face a new era of intense regulatory scrutiny, which began in 2002 and culminated in April, 2006, the effective date for each firm to conduct its own annual internal compliance review. Law firms like mine and others have rushed to the assistance of investment advisers, for example by conducting on-site mock SEC compliance audits of operations to satisfy the new SEC requirements. Even small investment advisers have had to earmark funds to hire outside compliance help. According to the Financial Planning Association, investment advisers spend between \$7,500 and \$15,000 annually for outside help.

During its examinations, the SEC now requests investment advisers to provide the following documents:

- Standard Operating Procedures for the risk identification and assessment process;
- A current inventory of compliance risks;
- Any document, such as a matrix or a spreadsheet, that maps the adviser's inventory of risks identified in the inventory of compliance risks to its written policies and procedures;
- All annual and interim reports regarding the review of the adviser's compliance program;
- Access to the adviser's budgets or financial plans for compliance activities during the inspection period; and,
- If the adviser has performed any forensic tests (i.e., compliance tests that analyze information over time in order to identify unusual patterns) during the inspection period, perhaps as a component of its annual review of its compliance program, a list of the forensic tests performed, and the corresponding objectives and result of each forensic test.

As one can see, the SEC is serious! Investment advisers need to be equally serious to avoid deficiencies in their SEC examinations. ■

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