

Compliance Survivor
Simplifying Complex Regulatory Concerns



PRESENTED BY:
Jeffrey M. Gershon

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Shaheen, Novoselsky, Staat,
Filipowski & Eccleston, P.C.
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Regulatory Issues

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Regulatory Issues

CONFLICTS OF INTEREST

- Requirement to disclose material conflicts of interest in a full and fair manner to ensure your clients understand any material conflicts of interest before taking action

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Regulatory Issues

DUTY TO DISCLOSE

- Under the Advisers Act, an adviser has a fiduciary obligation to act in the best interests of its client and to place its client's interest before its own

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Regulatory Issues

Examples of failure to disclose:

- Failing to disclose fees charged to a client
- How fees are charged; whether fees are negotiable
- Failing to disclose an affiliation with a broker-dealer, or solicitors

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Regulatory Issues

Examples of failure to disclose (contd):

- Failing to disclose that the adviser recommends securities to clients in which he has a proprietary interest
- Failing to disclose the risk by having clients invest in private investments (Illiquidity is an issue)

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Regulatory Issues

Examples of failure to disclose (contd):

- Failing to disclose the types of products and services it obtains through “soft dollar” arrangements
- Failing to explain to clients that they pay both a direct management fee to their advisers and an indirect fee to their advisers of their mutual fund

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Examples of failure to disclose (contd):

- Failing to amend its form ADV on an annual basis or updating information more frequently when it becomes out of date
- Stating that the adviser does not have custody and possession when in fact it does

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LACK OF INTERNAL CONTROLS

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Regulatory Issues

POLICIES AND PROCEDURES

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REQUIREMENTS

- Monitoring employees' personal trading
- Adopting effective or relevant compliance policies and procedures

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VIOLATIONS

- Front-running
- Scalping
- Trading on non-public information
- Taking investment opportunities for themselves

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Regulatory Issues

CUSTODY AND POSSESSION

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Record Keeping

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Record Keeping

BOOKS AND RECORDS

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Record Keeping

ADVERTISING

- Performance based
- Adviser Act Rules prohibit use of testimonials from clients regarding an adviser's services

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Record Keeping

ADVERTISING (contd)

- Advisers cannot use any advertising that contains any untrue statements of a material fact, or which is otherwise false or misleading

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Record Keeping

**FAILURE TO ACCURATELY STATE
PERFORMANCE RESULTS**

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Record Keeping

PERFORMANCE CLAIMS

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ADVISORY AGREEMENTS

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Record Keeping

RISK IDENTIFICATION PROCESS

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Record Keeping

EMAIL

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Record Keeping

ELECTRONIC STORAGE

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**SEC Investor Complaints
and Questions**

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SEC Investor Complaints and Questions

The SEC's investor assistance staff received 76,221 complaints, questions, and other contacts in 2005.

SEC Investor Complaints and Questions

COMPLAINT TYPE

| | |
|-----------------------------------------------------------------------|-------|
| 1. Advance Fee Fraud | 2,219 |
| 2. Spam: Unwanted Emails or Faxes | 1,146 |
| 3. Transfer of Account Problems | 844 |
| 4. Account Closing: Problems with Redemption, Liquidation, or Closing | 841 |
| 5. Manipulation of Securities, Prices, or Markets | 741 |
| 6. Bankruptcy or Issuer Reorganization | 728 |
| 7. Theft of Funds or Securities | 697 |
| 8. Unauthorized Transactions | 653 |
| 9. Account Records: Errors or Omissions | 645 |
| 10. Delivery of Funds or Proceeds | 629 |

SEC Investor Complaints and Questions

COMPLAINTS AGAINST BROKER-DEALERS ONLY

| | |
|-----------------------------------------------------------------------|-----|
| 1. Transfer of Account Problems | 622 |
| 2. Unauthorized Transactions | 533 |
| 3. Account Closing: Problems with Redemption, Liquidation, or Closing | 518 |
| 4. Account Records: Errors or Omissions | 433 |
| 5. Unsuitable Recommendations | 395 |

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**NASD Complaints:
Dispute Resolution Statistics**

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**NASD Complaints:
Dispute Resolution Statistics**

| | | |
|----------------------------------------------------------------|--------------------------------|-------------|
| CONTROVERSIES INVOLVED IN ARBITRATION CASES | Type of Controversy | 2005 |
| | Unsuitability | 1,926 |
| | Misrepresenta- tion | 1,826 |
| | Online Trading | 7 |

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**NASD Complaints:
Dispute Resolution Statistics**

| | | |
|-----------------------------------------------------------------|-----------------------------|-------------|
| SECURITY TYPES INVOLVED IN ARBITRATION CASES | Type of Security | 2005 |
| | Corporate Bonds | 106 |
| | Certificates of Deposit | 31 |
| | Mutual Funds | 888 |
| | Options | 153 |

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**NASD Complaints:
Dispute Resolution Statistics**

| SECURITY TYPES INVOLVED IN ARBITRATION CASES | Type of Security | 2005 |
|----------------------------------------------|----------------------|-------|
| | Common Stock | 1,348 |
| | Limited Partnerships | 24 |
| | Annuities | 460 |

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Suitability Revisited

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Suitability Revisited

Key Considerations:
(Seminar for the Securities Industry Association, Compliance and Legal Division)

- Does the activity make sense?
 - Irrelevant that client agreeable, or
 - Account performing well

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Digging the Hole Deeper

Or "No good deed goes unpunished."

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Digging the Hole Deeper

- Admitting that a past strategy was not a good idea
- Offering to waive fees or give a discount for poor performance

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Digging the Hole Deeper

- When a client does not have the stomach to take losses, don't fight him
- Sell a position that is going down and revise the questionnaire to reflect that the client "can't sleep" with certain investments

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Digging the Hole Deeper

Avoiding Digging the Hole Deeper

- If you and a client no longer have the same ideas about investing, end the relationship
- Document any time that a client took an action against your advice
- Never admit that an investment was a bad idea or a mistake
- Never give a refund/discount for services due to investments performing poorly

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Dealing With A Customer Complaint

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Dealing With A Customer Complaint

- Once a customer has made a written complaint, a reportable event has occurred
- **DO NOT** meet with the customer or communicate with the customer before speaking to an attorney
- Immediately notify any insurance carrier

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**Hedge Fund and
Fund of Funds
Due Diligence (NTM 03-07)**

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**Hedge Fund and Fund of Funds
Due Diligence (NTM 03-07)**

- Disclosing that hedge funds / fund of funds often engage in leveraging and other speculative investment practices that may increase the risk of loss
- Can be highly illiquid
- Are not required to provide periodic pricing or valuation information to investors

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**Hedge Fund and Fund of Funds
Due Diligence (NTM 03-07)**

- May involve complex tax structures and delays in distributing important tax information
- Are not subject to the same regulatory requirement as mutual funds
- Often charge high fees

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**Hedge Fund and Fund of Funds
Due Diligence (NTM 03-07)**

- **Must perform due diligence to determine that the hedge fund or fund of hedge funds is suitable for any customer**

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**Hedge Fund and Fund of Funds
Due Diligence (NTM 03-07)**

- **“Heightened responsibility” to investigate, and “substantial due diligence” to perform**

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**Hedge Fund and Fund of Funds
Due Diligence (NTM 03-07)**

- **Before making a recommendation to any customer, member firms must do at least the following:**
 - **Investigate the background of the hedge fund manager**
 - **Review the offering memorandum**
 - **Review the subscription agreements**
 - **Examine references**
 - **Examine the relative performance of the fund**

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**Hedge Fund and Fund of Funds
Due Diligence (NTM 03-07)**

- **Must perform a customer-specific suitability determination**
 - Customer’s wealth is not an indicator of suitability
 - Wealth does not provide a basis for recommending risky investments

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**Hedge Fund and Fund of Funds
Due Diligence (NTM 03-07)**

- **Furthermore, acting as a placement agent still may bring the firm within the definition of “recommendation”, citing NTM 96-60**
 - The firm brought the specific hedge fund or fund of hedge funds to the attention of the customer

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CPE credit candidates, please key in your answer in the Q&A field to the following question:

How long is an investment adviser required to maintain books & records?

- a) 1 year
- b) 2 years
- c) 5 years
- d) 10 years

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Answer:

c) 5 years

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CPE credit candidates, please key in your answer in the Q&A field to the following question:

Rule 206(4)-3 allows for cash payments for client solicitations if:

- a) the adviser is registered
- b) solicitor cannot be subject to statutory disqualification
- c) cash fee must be paid pursuant to a written agreement
- d) disclosure must be made to the client
- e) all of the above

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Answer:

e) all of the above

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QUESTIONS?

JGershon@SNSFE-law.com
312.621.4400

Answers to FAQ regarding our webinars:

- This presentation will be available for replay from our website at www.SNSFE-law.com along with a PDF of the PowerPoint slides within 48 hours.
- A 5-question participant evaluation will be emailed to you.
- Qualified CPE candidates will receive proof of attendance via email.

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THANK YOU

Shaheen, Novoselsky, Staat,
Filipowski & Eccleston, P.C.

20 N. Wacker Drive
Suite 2900
Chicago, IL 60606-9719

312.621.0268 (fax)

JEFFREY M. GERSHON
JGershon@SNSFE-law.com

312.621.4400

www.SNSFE-law.com
www.FinancialCounsel.com
