2009 CCOutreach Regional Seminars

The Evolving Compliance Environment: Examination Focus Areas

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Every investment adviser registered with the Commission must adopt and implement written compliance policies and procedures (a "compliance program"). Specifically, Rule 206(4)-7 requires an adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder by the adviser or any of its supervised persons. [1] The objective of a well-designed compliance program would be to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations of the Advisers Act that have occurred. To thoroughly evaluate a compliance program's effectiveness, examiners need to obtain sufficient information about the structure of an adviser's organization and operations to:

- Understand the risks and conflicts of interest present at the firm and the policies and procedures implemented to address such risks and conflicts;
- Determine the ability of the compliance program to detect, mitigate, and prevent compliance problems; and
- Evaluate the reasonableness of the firm's compliance monitoring processes and the remedial actions implemented by the firm once problems have been identified.

Examiners also evaluate the frequency, severity, and nature of the problems identified by an adviser's compliance program. Advisers with effective compliance programs generally will have: relatively fewer compliance breaches; problems that are not egregious; fewer repetitive compliance problems; issues identified on a timely basis; and problems that are promptly corrected.

Some areas examiners often review to evaluate the effectiveness of an adviser's compliance program are discussed below. The procedures discussed are considered best practices, but are not required by federal securities laws. The staff believes that these procedures, if carried out

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[1] See the Compliance Rule" (Rule 206(4)-7 under the Investment Advisers Act of 1940 ("Advisers Act")) and the Compliance Rule adopting release: *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release No. 2204, Dec. 17, 2003 (available on the SEC's website at http://www.sec.gov/rules/final/ia-2204.htm).

competently and independently, could significantly enhance an advisory firm's compliance program.

I. Understanding an Adviser's Compliance Program

A. Identifying Compliance Risks and Conflicts of Interest

Investment advisers are exposed to numerous risks and conflicts of interest that can result in harm to investors and may cause a firm to deviate from regulatory requirements. Many risks and conflicts of interest are common among firms. Examples of such risks and problems include portfolio managers making decisions that are contrary to a client's investment objectives, traders placing orders for clients' accounts to generate soft dollar credits rather than seeking best execution, and misrepresenting investment performance of a fund to enhance its position in the competitive marketplace. However, advisers may also have risks and conflicts of interest that are unique as a result of the firm's organizational arrangements, affiliations, business partners, diversity of client base, products and services offered to clients, geographical locations, and personnel.

To implement a compliance program reasonably designed to prevent violations of the Advisers Act and rules thereunder, each adviser should identify the risks and conflicts of interest that are relevant to its business. The identification process should be repeatable and firm-wide. Such a process may include any or a combination of the following:

- Top-down: a simple approach to risk assessment in which management identifies the conflicts of interest and other risks the firm confronts.

- Layered: committees are used to identify the conflicts of interest and other risks present within each area of expertise (*e.g.*, portfolio management committee, brokerage committee, pricing committee, IT oversight committee, internal controls committee and corporate governance committee). Such committee input is compiled and summarized into a firm-wide program.

- Bottom-up: each employee or group of employees provides input regarding the potential conflicts of interest and other risks that the firm confronts in the employees respective areas of expertise.

- Dedicated risk staff: a group of individuals are responsible for managing the risk assessment process and ensuring risks are properly assessed, inventoried and managed.

Regardless of the process used by an adviser to identify its risks, the end result of the firm's risk assessment process should be an inventory of potential risks that reflects the current environment of the firm. Such an inventory of risks should not be static. In addition to gathering and analyzing information about an adviser's risk assessment process, examiners review the firm's inventory of risks and determine whether it is current and sufficiently comprehensive.

B. Mapping Potential Compliance Risks to Policies and Procedures

An effective compliance program could include a standardized process for creating written policies and procedures to address each risk in its inventory. Similar to the process for identifying risks, the process for creating and maintaining corresponding policies and procedures should be an evergreen process and also may be structured as a top-down, layered, bottom-up, or dedicated risk staff process.

The written policies and procedures established by an adviser should create the necessary separation of duties vital to the creation of an effective control environment and should address responsibilities for the administration and oversight of each risk area. Typically, such policies and procedures dictate that testing and reconciliations are built into routine operations, require that periodic exceptions and completion reports be prepared, and address the process for escalating information and reporting to higher levels of management.

As part of their assessment of the compliance program, examiners typically evaluate an adviser's process for creating effective policies and procedures to manage and control the risks present at the firm.

C. Implementing Policies and Procedures

The goal of implementing an effective compliance program is to facilitate the adviser fulfilling its fiduciary duty and its disclosure obligations to clients and to guide the firm toward operating in a manner that is consistent with the Advisers Act. Thus, compliance with the policies and procedures should be an integral part of daily operations. In addition, routine testing of information and operations should be done against established guidelines and limitations to identify exceptions that need to be followed-up. Implementation of policies and procedures also covers the follow-up work required to investigate exceptions and outlier results and information and remedial actions taken to correct non-compliant practices.

Examiners typically evaluate the implementation process used by an adviser, including oversight activities by the CCO, to assist in determining if the compliance program is effective.

D. Monitoring the Effectiveness of the Policies and Procedures

One goal of compliance programs is to prevent compliance problems from occurring. However, some compliance breaches still may occur. As a result, examiners expect to find exception reports, compliance checklists, and management reports that note problems and issues. Conversely, if a review of compliance records and/or a discussion with an adviser's compliance staff reveals that the firm has not found any compliance problems during its reviews, an examiner may be skeptical of these results and conduct additional testing to confirm such an outcome. To evaluate the timeliness with which compliance problems are found and corrected, examiners request information from the adviser regarding: when problems were found; when the problems occurred; when and how each such problem was resolved; and whether factors that allowed the problem to happen were identified, corrected, or improved.

Monitoring the effectiveness of a compliance program includes conducting transactional testing, analyzing exception reports, and conducting forensic tests. Forensic tests are designed to identify patterns of data that represent anomalies with respect to expected outcomes and may identify weaknesses in a firm's compliance program that are not readily evident. Such anomalies may be indicators of possible fraudulent conduct. Forensic tests corroborate the results of daily transaction tests and the related exception and management reports.

Each adviser is required by the Compliance Rule to conduct at least an annual review of its compliance program. However, ideally, the process of reviewing and evaluating compliance risks and policies and procedures should be a continuous part of any compliance program. For example, problems identified in exception reports or as a result of forensic testing may require analysis of the firm's operations in select areas, evaluation of the control procedures in those areas, and corrective action. The rule does not require the CCO of an adviser to prepare a report that summarizes the results of the annual review. However, it is a good business practice to prepare a report to document the work that was performed, the findings from the review, and the recommendations for improvements. This information is frequently requested and reviewed by examiners to determine the effectiveness of an adviser's own reviews.

II. Examination Focus Areas

Discussed in more detail below are some areas examiners review, deficiencies they uncovered, and controls they have observed which may be effective for each of these areas of special emphasis. When determining areas to review, the staff assesses the conflicts of interest and risks that are present at a particular firm and the extent to which the firm's compliance program mitigates and manages those conflicts and risks. The existence of a conflict or risk does not suggest that a deficiency will be present. Advisers should note that the risks identified and specific procedures discussed do not represent an exhaustive list and are not required by the federal securities laws

Examiners assess whether an adviser has engaged in any activity that conflicts with the interests of the adviser's clients, validate that the firm has employed reasonable care to mitigate and manage such risks and to avoid misleading clients, and evaluate whether the adviser has provided full and fair disclosure of all material facts to clients and prospective clients. In today's evolving economic and regulatory environment, examiners are placing special emphasis on the following operational areas: portfolio management, outsourcing services, safeguarding client funds and securities, performance claims, and valuation.

A. Portfolio Management

The term "portfolio management" covers a broad array of advisory activities. It includes the allocation of investment opportunities among clients, the consistency of portfolios with clients' investment objectives, disclosures to clients, and consistency of operations with applicable regulatory requirements and the firm's code of ethics. Because of their importance, these areas are typically reviewed during all examinations.

Risks in the area of portfolio management are greatly dependent on an adviser's operations, services, affiliations, and the specificity of guidelines and restrictions clients place on the firm regarding their individualized services. Also relevant is how the firm handles its receipt of non-public information, and how the firm maintains the confidentiality of information regarding its clients.

1. Understanding the Firm's Business and Operations

When examiners review the activities of an adviser, they analyze the firm's business operations, business relationships, affiliations, and disclosures to confirm that the adviser has procedures in place to ensure that: it only engages in investment decisions that are consistent with client mandates and objectives; it reviews accounts to confirm consistency; and it provides full and complete disclosure to clients regarding portfolio management services. In addition, the staff confirms that there is a framework for testing whether investment decisions have been allocated equitably among eligible clients.

Conflicts of interest and other risk areas may include:

- Adviser has discretionary authority.

- Adviser manages different types of accounts in a parallel manner (*i.e.*, registered investment company, private investment company, and/or separately managed accounts – all with the same investment objective).

- Adviser manages accounts with competing investment strategies (*i.e.*, long-only accounts and accounts that concentrate on shorting stocks).

- Adviser manages accounts with differing compensation structures (*i.e.*, performance-based compensation versus asset-based management fees).

- Adviser makes proprietary investments in the same securities that are recommended to clients.

- Adviser invests client assets in affiliated entities.

- Adviser votes client proxies.

2. Identifying Deficient Practices and Control Weaknesses

Deficient practices might exist in situations where firms did not: adopt or maintain policies and procedures relating to the firms' investment decision-making; maintain required books and records to corroborate investment decisions (e.g., trade tickets and confirmations); and/or disclose all conflicts of interest to clients that may affect the impartiality of the advisers' investment decisions (e.g., a material relationship, compensation arrangement or other conflict of interest). The severity of the issues identified during an examination with respect to an adviser's portfolio management review may vary.

Below are examples of questions examiners may ask to determine if an adviser has deficient practices and control weaknesses:

- Does the adviser have processes, including supervisory procedures, to ensure that the investment advice provided to each client is consistent with: (a) the client's circumstances, expectations, restrictions, direction, and risk tolerance; (b) the information provided to each client in brochures, marketing materials, contracts and otherwise; and (c) the regulatory regime?

- How does the adviser ensure that its compliance policies and procedures are adequate with respect to the investment advice the adviser provides?

- Does the adviser have an effective means for evaluating investment decisions after implementation to determine if outcomes were consistent with clients' expectations and restrictions? If outcomes deviated from expectations, were appropriate remedial actions taken?

- Does the adviser maintain current and complete information regarding each client's financial and family circumstances, investment objectives and restrictions, and risk tolerance?

- Does the adviser maintain an effective due diligence process through which all relevant features and risks associated with proposed investment products, styles and processes are vetted and approved before being implemented?

- Are the adviser's investment recommendations consistent with the disclosures made to clients? Do its investment recommendations carry a greater or lesser risk than disclosed to clients?

- If the adviser uses an approved list of investments, how does it ensure that actual client investments are consistent with this list?

- Does the adviser recommend derivative instruments, such as swaps and inverse floaters? Is its client accounting system able to fully accommodate the sometimes unusual terms and conditions relating to these instruments?

- Does the adviser have effective processes to identify, contain, and prevent the unauthorized and/or inappropriate use of non-public information that comes into its possession?

- If the adviser's employees come into possession of non-public information, is this information effectively identified, documented, and contained so that it is used appropriately?

- If the adviser's employees come into possession of non-public information about an issuer as a result of a client's position in that issuer (e.g., a participation in a bank loan), is this information controlled effectively so that it is not used to unlawfully trade in other instruments of the issuer (e.g., shorting the issuer's equity if the issuer's financial condition deteriorates)?

- If the adviser provides investment advice to clients regarding companies with which the adviser has business relationships, does the adviser have processes to prevent providing conflicted investment advice to clients and to ensure that clients receive full and fair disclosures regarding these conflicts?

- Does the adviser engage in "window dressing" (i.e., are decisions to effect trades in client or proprietary accounts undertaken in an attempt to manipulate the closing price of a security or to be able to present to clients a list of portfolio positions that is consistent with their investment objectives but which is substantially different than the positions held in between reporting periods)?

- How does the adviser deal with conflicts in advice it gives to clients (e.g., advising one client to sell a thinly traded security, while at the same time recommending that another client purchase the same security)?

- Is portfolio turnover (frequency and amount of trading in clients' accounts) consistent with clients' investment objectives, or is it the result of decisions by employees to generate commission credits that the adviser can use for its own purposes?

- How does the adviser prevent cherry-picking of favorable trades on behalf of favored clients or proprietary accounts? Are changes in order allocations consistent with its fiduciary relationship with clients, code of ethics, and disclosures?

- How does the adviser prevent scalping of investment advice provided to clients (i.e., the illegal practice of recommending that clients purchase a security and secretly selling the same security in a personal or proprietary account contrary to the recommendation)?

- Does the adviser have any side letters or agreements with any participant in a pooled vehicle the adviser advises or manages? Are the terms and conditions of these agreements consistent with the adviser's disclosures to clients and pooled vehicle participants?

- Does the adviser vote proxies consistent with its proxy voting policies and procedures, disclosures to clients, and status as a fiduciary?

- Is documentation or other output generated to substantiate that the adviser obtained all information related to providing investment advice in a timely, accurate, and complete manner?

3. Controls Observed

An adviser should have controls to ensure that the policies and procedures in place with respect to its portfolio management functions are adequate to detect fraudulent conduct and decrease the ability for personnel to perpetuate and conceal fraudulent activity. Below are examples of such controls examiners have observed.

- Adviser has segregation of duties (when practicable) among personnel performing certain functions – especially portfolio management and marketing and portfolio management and valuation of clients' positions.

- Adviser performs forensic testing to identify accounts or portfolio managers that have outlier performance and determines the cause for these unusual results.

- Portfolio managers periodically review offering documents, client contracts, disclosure information, and/or marketing materials to ensure that the strategy or investments utilized are accurately described and that accounts are managed consistently.

- Adviser periodically reminds clients of their need to update the firm of any changes in their contact information, objectives or financial situation and documents all changes received (whether they are received verbally or in writing).

- Adviser carefully considers appropriate procedures to address those situations in which the firm might benefit from client relationships or transactions (*e.g.*, if the firm keeps the proceeds from the correction of trade errors that were profitable, are the firm's procedures adequate to address the conflicts?).

- Adviser establishes front-end compliance parameters to ensure that client mandates, such as restrictions and diversification standards, are followed.

- Adviser provides disclosure (rather than merely offering to provide disclosure) and discusses highlights and changes during periodic client communications.

- Clients are informed of violations of restrictions and the corrective action taken – even if it was promptly found and corrected.

- Adviser regularly reviews the Commission's website for changes to required practices and recent enforcement actions and reconciles these developments with the firm's policies and procedures to determine if updates are warranted.

B. Outsourcing Services

An adviser may choose to engage service providers to perform a number of important services for advisory clients, including management or contractual responsibilities. Service providers often serve as administrator, pricing agent, proxy voting agent, and/or fund accountant. These service providers may: provide financial reporting, tax and regulatory services; create and maintain required books and records; value portfolio securities and accounts; prepare regulatory filings; calculate client account expenses; vote client proxies; and monitor arrangements with other service providers. However, when a service provider is utilized, the adviser still retains its fiduciary responsibilities for the delegated services. As a result, advisers should review each service provider's overall compliance program for compliance with the federal securities laws and should ensure that service providers are complying with the firm's specific policies and procedures.

1. Understanding the Firm's Business and Operations

Examiners review an adviser's disclosures, contracts with clients, and contracts with service providers to determine whether the services and reporting obligations are consistent with disclosures and that all obligations are adequately addressed and overseen by the adviser. Examiners assess whether the adviser is familiar with the service provider's staff responsible for performing the contracted services and assess whether the advisory staff assigned to review the documentation and information received from the service providers are adequately overseeing the service provider's activities. For example, if the service provider utilizes internal audit to review its services and operations, does advisory staff overseeing service providers inquire as to the topics covered by these reviews and seek to learn whether there were any material deficiencies? The staff will review whether the adviser's staff responsible for service provider oversight ensures that the services are implemented as agreed upon and monitors compliance with the contracted terms and conditions. The staff will also focus on identifying any undisclosed arrangements between the adviser and the service providers, such as fee rebates or tie-ins.

Conflicts of interest or risk areas may include:

- Adviser relies heavily on service providers.
- Adviser changes service providers.
- Service provider modifies its reporting processes or procedures.
- Adviser and service provider (or its principals) are "related persons."

2. Identifying Deficient Practices and Control Weaknesses

Deficient practices might exist in situations where firms did not: adopt or maintain policies and procedures relating to the firms' use of service providers; adequately oversee the activities of services providers; and/or disclose any affiliations and related conflicts of interest related to the use of a service provider.

Below are examples of questions examiners may ask to determine if an adviser has deficient practices and control weaknesses:

- Does the adviser obtain a confidentiality agreement from third-party service providers that may be given access to confidential client information? Have service providers inadvertently disclosed such information?

- Does the adviser represent that the service provider is "independent" when, in fact, the firms are under common control or otherwise have a close connection that should be disclosed?

- Does the adviser periodically verify that the fees deducted from client accounts are consistent with contractual terms? Have clients overpaid fees?

- Do clients pay excessive and duplicative fees for administration and/or accounting services?

- Does the adviser take steps to validate the accuracy of pricing provided by third parties?

- Are there any arrangements whereby clients make payments to various third-party service providers and, in turn, the service providers make payments directly to the advisers ("quid pro quo" arrangements)?

- If the adviser recommends other managers to clients, does the adviser have policies and procedures regarding researching and monitoring separate account managers and mutual funds?

- Does the adviser use client funds to pay third-party consultant fees that should be paid by the adviser?

- Does the adviser deem a contractor with access to client investment recommendations to be an access person?

3. Controls Observed

Advisers should perform adequate initial and on-going due diligence of each service provider to confirm that the contracted services and the implementation processes are appropriate for the firm and its clients. Such due diligence is important when reviewing the services provided by both affiliated and third-party service providers. Below are examples of such controls examiners have observed.

- Adviser periodically reviews the qualifications and oversight capabilities with respect to the specific services that the adviser has delegated to the service provider.

- Adviser evaluates the effectiveness of the reports prepared by the service provider for the adviser (i.e., types of reports produced and conditions under which exceptions are raised to the firm's attention) and the appropriateness of the frequency with which the reports are produced.

- Adviser ensures that the service providers are performing all contracted functions.

- Adviser verifies that the servicer provider is creating and maintaining the documentation necessary to ensure that such records are compliant with the federal securities laws and the needs of the firm.

- Service provider makes restitution if specific events go wrong.

- Adviser verifies that its service providers are aware, compliant, and current with regard to the federal securities laws and firm policies and procedures.

- Adviser makes periodic on-site visits to the service provider's facilities to view operations in action.

C. Safeguarding of Client Assets

Advisers should have policies and procedures in place to address how they will safeguard clients' funds and securities and to set protocol for establishing custodial arrangements and communicating with client custodians. Advisers should evaluate their security measures established and implemented to protect confidential personal information and to prevent unauthorized use of such information.

1. Understanding the Firm's Business and Operations

Examiners regularly confirm advisory records with records received directly from third-parties in order to independently verify investor assets. Verifying assets may involve contacting the following entities and persons directly:

- bank and broker-dealer custodians;
- administrators;
- investors in hedge funds managed by the adviser;
- advised clients;
- derivative counterparties;
- hedge fund administrators and/or managers to hedge funds that advised clients are invested in;

- National Securities Clearing Corp. (“NSCC”);
- Depository Trust & Clearing Corp. (“DTCC”); and
- auditors for the advisory firm and/or investor accounts.

The asset confirmation process is intended to be multi-layered. It includes a reconciliation of the information and records provided by the adviser to the staff with records and information received directly by the staff from the adviser’s various custodians. It also includes a reconciliation of the information provided by the adviser to its clients with the information that was provided about those clients to the staff by the adviser. In addition, the staff’s confirmation process involves independent confirmation from an unaffiliated entity that a sample of the transactions that are included in an adviser’s trade download were entered into as reported. If the custodian or executing broker is an affiliated broker-dealer, the staff will also confirm information with DTCC and NSCC or another appropriate entity.

In instances where the examination staff is confirming account balance information directly with clients, the examination staff will ask certain clients to confirm that the adviser’s representation to us of each respective client’s account balance as of a specific date is consistent with the records received by that client and that the client’s contributions to and withdrawals from the account over a period of time were authorized to occur. In requesting confirmations from investors in hedge funds managed by registered advisers, the staff will request that such investors confirm that their capital account balances, as shown by the funds’ records, are consistent with the investors’ records.

Conflicts of interest and other risk areas may include:

- The adviser is in a precarious financial condition.

- The adviser and qualified custodian are affiliated.

- Client funds or securities are held at a foreign financial institution.

- The auditor of the adviser or client is inexperienced in conducting audits or surprise verifications.

- The adviser charges performance fees.

2. Identifying Deficient Practices and Control Weaknesses

Examiners seek to determine whether client funds or securities have been lost, misused, misappropriated, or subject to the adviser’s financial reverses, or are susceptible to any of such losses. In order to determine whether such losses have occurred or may occur, examiners need to gain a clear understanding of the relationship between the adviser and the various custodians that hold client securities and of the relationships between the adviser and its clients. Business dealings between advisers and clients outside of the advisory relationship are also closely scrutinized as are situations where the adviser faces financial difficulties.

Below are examples of questions examiners may ask to determine if an adviser has deficient practices and control weaknesses:

- Are client assets held in accounts maintained by qualified custodians as required by Rule 206(4)-2?

- If the adviser inadvertently obtains possession of clients' assets (e.g., if a client sends the adviser stock certificates), are required actions taken within the time periods specified in Rule 206(4)-2 to dispose of those assets?

- Does the custodian of each client's account independently monitor corporate actions (e.g., stock splits, dividends) affecting the account?

- Does the custodian of each client's account independently determine the value of each position on a date near the date of each statement sent to the client and communicate such valuations and the total value of the account in its statements sent to clients?

- Are securities lending practices that involve loans of clients' securities consistent with clients' contracts and disclosures made to clients?

- Does the adviser have a reasonable basis for believing that all clients receive periodic statements directly from their qualified custodians? Do these statements describe all activity in their accounts? Are these statements accurate (i.e., fully and fairly reflect transactions in and balances of each account during the periods covered by the statements)? If statements are not received directly from the custodian, is the information contained in account statements provided to clients regularly verified by a knowledgeable person that has no access to clients' assets to determine the truthfulness of transactional, balance and performance information?

- If the adviser is the only source of information provided to clients regarding activity in and balances of their accounts (i.e., no custodial statements are sent to clients), are those accounts subject to annual, unannounced surprise audits by an independent public accountant? Do those audits include confirmation of account activity and balances directly with clients?

- If one or more client's account holdings are subject to a surprise audit, does the accountant file Form ADV-E with the SEC within 30 days after the completion of the examination?

- Does the adviser periodically verify the postal/e-mail addresses to which clients' account statements are sent (both by the adviser and client custodians)?

- Does the adviser test the names and addresses used by clients' custodians to send statements to clients for unusual patterns of use of post office boxes or use of the same address for multiple clients and compare such names and addresses to information maintained by the adviser and follow-up as needed for all discrepancies and anomalies?

- Does the adviser regularly reconcile account balances and transaction detail shown on its records with information reported by clients' custodians? Is there follow-up to resolve all reconciling items?

- Are pooled vehicles over whose assets the adviser has custody annually audited by an independent public accountant?

- Does the accountant performing the financial statement audit of each pooled vehicle confirm with all participants in the pool their capital account balance and appropriately follow-up on any discrepancies identified?

- Does the accountant send a copy of the pooled vehicles' audited financial statements directly to each participant in the pooled vehicle or to a representative of the participant?

- Does the adviser or its advisory representatives maintain business or personal relationships with clients' custodians? Does the adviser personally benefit in some way from clients' relationships with those custodians (e.g., borrowing at below market rates)? If the adviser or its advisory representatives benefit, does the adviser disclose this and/or has the adviser established policies and procedures to mitigate any perceived risks?

- Are the adviser's clients fully and fairly informed of its practices for safeguarding clients' assets, including possible exceptions to these practices, and able to give their informed consent to all material conflicts of interest that arise from such practices?

- With respect to custody or safekeeping for each client asset and liability, is documentation or other output generated to substantiate that the adviser obtained all related information in a timely, accurate, and complete manner?

3. Controls Observed

Examiners review adviser's policies, procedures, and practices to determine whether the firm has implemented effective controls that encompass all means through which the firm or its representative may gain access to clients' funds and securities. Below are examples of such controls examiners have observed.

- Adviser has procedures to ensure that all clients' funds or securities are held by a qualified custodian and that such assets are maintained in separate accounts for each client.

- Adviser has records showing that clients have consented to their funds or securities being held by each custodian and the adviser ensures that custodians send quarterly (or more frequent) statements to clients.

- Adviser has procedures in place to ensure that it does not receive client funds or securities, or if received, they are promptly returned to the client.

- Adviser reconciles custodian statements to its internal records.

- Adviser has procedures in place to ensure that it calculates advisory fees and transmits the invoice to the custodian in a manner that is consistent with client agreements.

- Advisers that use omnibus trading accounts have procedures to ensure that only client securities are deposited or held in that account.

- Advisers that use foreign financial institutions that are qualified custodians have a reasonable basis for believing that the foreign institution will provide a level of safety and segregation for client funds or securities similar to that which would be provided by a qualified custodian in the U.S.

- Advisory agreement does not include a general power of attorney over the client's advisory funds or securities.

- Adviser has procedures in place to routinely verify (perhaps on a sample basis) the amount of advisory fees charged, preferably by a person other than the one who originally calculated the fees.

- When appropriate, adviser has ensured it has received client consent to have the qualified custodian send quarterly account statements to independent representatives.

- Pooled investment vehicles are audited annually by a reputable auditor.

- Adviser reviews organizational and offering documents to verify that such records clearly identify who has the authority to authorize disbursements from the pooled investment vehicle and how that authority can be exercised.

D. Performance Claims

An adviser's performance claims must not be false or misleading and must not contain any untrue statement of a material fact. Advisers should have policies and procedures in place to verify the accuracy of the performance information provided in materials to solicit new clients and report to existing clients. A review of an adviser's performance claims should include a verification of the actual computation used and resulting returns, account inclusion or exclusion criteria, maintenance of required books and records, and process for ensuring that clear disclosure is provided.

1. Understanding the Firm's Business and Operations

If the marketing of performance results is instrumental in the firm obtaining new clients, examiners will likely spend a considerable amount of time analyzing performance information because there is a greater risk that omissions of information and misrepresentations may harm potential and existing clients. To ensure that an adviser's marketing and performance information is fair and accurate, examiners seek to understand the mathematical formula used to compute the performance, the accounts included in any composite information provided, the medium through which performance returns are distributed, and the disclosures accompanying the advertised returns and the context in which they are provided.

Forensic metrics are particularly helpful in identifying aberrant performance returns, including:

- "Smoothing" - auto correlated analysis that identifies consistently-reported returns. These types of consistent or "smooth" returns could indicate that firms are providing inaccurate returns so that gains and losses appear more regular and less variable than they really are.

- "Outlier" Performance - calculated with two risk-adjusted performance metrics (alpha and information ratio) by comparing returns to a peer group and identifying the most extreme returns within each group and metric.

- Bias Ratio - identifies abnormalities in the distribution of a series of investment returns and examines "month-to-month changes in net asset value" against various statistical return patterns. Intended to identify performance with positive returns over a period.

Conflicts of interest and other risk areas may include:

- Adviser relies heavily on a paper-based record-keeping system.

- Adviser continuously updates its website.

- Adviser manages several strategies and has varying account types (i.e., institutional, retail, pooled investment vehicles).

- Adviser regularly loses existing clients and obtains new clients.

- Adviser employs portfolio managers with impressive performance returns that were earned while employed elsewhere.

- The adviser has limited personnel resources.

- Advisory staff performs multiple functions (such as compliance oversight and marketing).

- Portfolio managers' compensation is performance-based.

- Performance is heavily marketed and is responsible for most of the adviser's new business.

- Adviser completes requests for proposals and/or provides information for performance and consultant databases.

- Thinly traded securities, derivatives, or other difficult-to-value investments are included in performance figures.

2. Identifying Deficient Practices and Control Weaknesses

Examiners frequently find that advisers lack any compliance policies and procedures governing marketing and performance advertising or that the firms maintain procedures that appear to not be effective. Also, examiners often find that advisers have not included all of the disclosures necessary in their advertisements to prevent the information presented from being misleading. Many deficiencies also relate to inappropriate inclusion or exclusion of information, such as inappropriately advertising past specific recommendations. The most egregious practices are generally those where the adviser knowingly made false statements, or should have known that the information presented was false.

Below are examples of questions examiners may ask to determine if an adviser has deficient practices and control weaknesses:

- Does the adviser have adequate controls in place to review, approve, and monitor the creation and dissemination of marketing materials?

- Does the adviser circulate marketing materials containing false, misleading, or inaccurate information and fail to include required disclosures in marketing materials?

- Does the adviser provide performance information regarding its private investment funds to the general public on the non-restricted portion of its website?

- Does the adviser disclose that certain accounts are excluded from composite returns for various reasons (e.g., accounts with investment restrictions or that have more than 10% of assets in an unmanaged security are excluded from the composite)?

- Does the adviser exclude certain fees and expenses in the performance returns while disclosing that such fees are included?

- Are performance returns compared to an inappropriate benchmark and/or does the adviser omit information relevant to highlight notable differences between its performance composite and the benchmark?

- Are performance results presented in a consistent manner?

- Does the adviser maintain backup information to support advertised performance numbers?

- Does the adviser include outdated or stale performance and/or ranking information?

- Does the adviser determine fair values for certain securities? Are these values questionable and/or do they affect the performance results?

- If the adviser advertises performance returns its portfolio managers achieved while managing portfolios at a predecessor investment adviser, does the adviser have supporting documentation regarding the prior returns?

- Are model and composite performance figures, formulas, and related disclosures contained in communications to clients consistent with the adviser's status as a fiduciary?

- Are representations that composite performance shown in communications with clients is presented in conformity with a specified industry standard consistent with the requirements of that standard?

- Are advertisements that must be cleared by the NASD before use or filed with the NASD after use done so on a timely basis?

- Are all communications with clients provided by advisory representatives reviewed and cleared as required by the adviser's policies?

- Are the adviser's marketing and performance advertising practices fully and fairly disclosed to clients?

- With respect to performance advertising, is all required documentation or other output generated to substantiate that the adviser obtained all related information in a timely, accurate, and complete manner maintained pursuant to Rule 204-2(a)(16)?

3. Controls Observed

Examiners will typically select a number of accounts from several strategies or categories and, using internal reports and/or workpapers, verify the dates and amounts of cash flows into the accounts and reconcile this information to third-party documents (*e.g.*, brokerage or custodian statements). The staff generally finds fewer compliance breaches in instances where the adviser: has detailed performance and marketing policies and procedures; receives performance verification reports from a reputable firm; produces exception reports that compare individual account returns versus composite returns as a test for dispersion; and have a list of dedicated employees who perform relevant marketing functions. Below are examples of such controls examiners have observed.

- Adviser requires minimum professional training or standards for staff preparing marketing materials and calculating performance returns (e.g., advanced degrees or professional designations).

- Adviser has written policies and procedures to ensure standardization and quality of marketing materials.

- Data maintenance and performance measurement are separate from portfolio management and marketing (segregation of duties).
- Marketing materials are reviewed by dedicated compliance staff.
- Audit or other reviews are conducted by a competent outside compliance entity.
- Adviser uses "tolerance reports" on a monthly basis to compare all composite accounts to their respective benchmarks, with any material discrepancies being investigated.
- Adviser implements a multi-level review process among its performance group, portfolio managers, and marketing group for the accuracy of marketing materials prior to their use.

E. Valuation of Client Assets

Advisers should have adequate internal controls and verification processes to detect situations where market values materially deviate from values used to price client portfolios.

1. Understanding the Firm's Business and Operations

The primary risk with respect to pricing client portfolios is over-valuation for purposes of calculating advisory fees and performance fees and figures. Advisers should have adequate internal controls and verification processes to detect situations where market values materially deviate from values used to price client portfolios. Examiners focus on an adviser's processes and procedures for pricing client portfolios to ensure that accurate portfolio values are communicated to clients and are used to calculate advisory fees and the adviser's performance returns.

Conflicts of interest and other risk areas may include:

- Adviser has no way of determining an accurate value for certain illiquid, restricted, thinly traded, or private securities held by clients.
- Prices are derived from matrix or yield curve formulas.
- Portfolio managers and/or traders are responsible for pricing client portfolios.
- Portfolio managers/traders receive performance-based bonuses.
- Portfolio managers or others are able to over-ride prices obtained from the usual pricing source.
- Adviser relies on service providers to price client portfolios.
- Adviser manages "fund-of-funds" investments.

2. Identifying Deficient Practices and Control Weaknesses

Examiners verify that the adviser has established appropriate operational procedures and supervisory structures for overseeing the integrity of both pricing service valuations and any "manually priced" securities.

Below are examples of questions examiners may ask to determine if an adviser has deficient practices and control weaknesses:

- Does the adviser perform adequate and on-going due diligence on the methodologies used by all entities, such as pricing services, that provide pricing information used to value clients' positions?

- Do the prices used to value clients' positions consistently reflect the price(s) that would be paid or received in a transaction with a knowledgeable and willing counter party at the time the pricing was performed?

- Are the prices used to value clients' holdings based on the appropriate quantities of each position (i.e., match the quantities of each position as reported by the client's custodian)?

- Do other assets (e.g., cash, receivables and prepaid items) and liabilities (e.g., payables) that are used in determining the gross and net value of clients' accounts consistently reflect the current value of these items at the time of the calculation?

- If the adviser manages a pooled investment vehicle and moves positions into a "side pocket," is the value applied to those positions consistent with the adviser's pricing policies and procedures?

- If an error is made when calculating the gross or net value of clients' positions or the net asset value of pooled accounts, is the error corrected in a way that is consistent with disclosures and the adviser's fiduciary duty to clients?

- Is the adviser's process for calculating the NAV of pooled clients' accounts and allocating the NAV of pooled vehicles among participants consistent with the pooled vehicles' policies, disclosures, and the adviser's fiduciary duty to clients?

- Taking into account the volume and timing of transactions in pooled vehicles that the adviser advises, do the valuations that make up the NAV fairly represent each participant's ownership interest?

- Are the adviser's clients fully and fairly informed of its process for valuing clients' positions, including possible exceptions?

3. Controls Observed

The adviser should have pricing procedures in place that are periodically evaluated by management to ensure that client portfolios are being priced objectively. If the adviser becomes aware of any price inaccuracies, examiners will verify that the adviser took reasonable steps to determine a market valuation or assign security prices based on its own internal efforts at fair valuation. Forensic tests are very helpful in assessing the adequacy of compliance policies and procedures in this area. Below are examples of such controls examiners have observed.

- The accuracy of prices is evaluated and/or verified.
- Pricing sources are regularly re-evaluated, including methodology used and accuracy of prices provided.
- Exception reports are generated and reviewed.
- Compliance checklists are regularly completed, reviewed, and maintained.
- Internal audits are conducted and reports are generated and reviewed. Any recommendations made by the audit team are brought to management's attention and implemented in a timely manner.
- Management reports are generated and reviewed.
- Self assessments are completed and any issues noted are promptly addressed.
- For all manually priced securities, the adviser periodically obtains prices from another source, independent of the usual source, to check the accuracy of prices provided by the primary source. Appropriate follow-up and adjustments occur as a result of these comparisons.
- Portfolio managers have a role in supplying prices used or valuation of assets held by advisory clients only when valuations by more objective sources are unavailable.
- All pricing overrides are documented and supervisory approvals are obtained in writing. Compliance personnel periodically review overrides and also look for patterns that suggest manipulation. Appropriate follow-up is conducted.
- The adviser maintains documentation of all quotes received from third-party sources.
- The adviser has controls to avoid or mitigate potential conflicts of interest relating to the pricing of client portfolios.