

*2009 CCO Outreach  
Regional Seminars*

# *Disclaimer*

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# *Population Information*

## Registered Entity Statistics As of 12/31/08

- 11,292 registered investment advisers
- 1082 registered investment companies
  
- Approximately 10.50% IAs located under Boston Regional Office jurisdiction
- Approximately 12.20% ICs located under Boston Regional Office jurisdiction

# *Examination Information*

## Investment Adviser Exam Statistics for Fiscal Year 2008

- 1,521 investment adviser exams conducted
- Examination dispositions:
  - 64% - Deficiency letter
  - 31% - No-further action letter
  - 4% - Enforcement referral
  - 1% - Other

# *Examination Information*

## Investment Company Exam Statistics for Fiscal Year 2008

- 219 investment company complex exams conducted
- Examination results:
  - 67% - Deficiency letter
  - 27% - No-further action letter
  - 5% - Enforcement referral
  - 1% - Other

# *Evolving Compliance Environment*

- Recent significant market, economic, and regulatory developments
- Firm-specific operational and structural changes
- Impact on advisers' businesses and operations
- The need to reassess risks and modify compliance program

# *SEC Examinations Today*

- Changing Examination Priorities
  - Focus on detecting significant infractions sooner
  - Focus on procedures firms instituted to attempt to prevent such actions from occurring in the future

# *SEC Examinations Today*

- Specific Areas of Focus:
  - Portfolio Management
  - Safeguarding Funds and Securities
  - Protecting Non-Public Information
  - Dually Registered Firms
  - Ensuring Adequate Supervision
  - Protecting Senior Investors



# *SEC Examinations Today*

- Follow-Up Actions in the Wake of Recent Events
  - Changes in examination frequency;
  - Increased focus on identifying the existence of unregistered advisers and funds and unregulated products;
  - Targeting firms for examinations to verify the existence of client assets;
  - Improving the assessment of risk

# *SEC Examinations Today*

- Follow-Up Actions in the Wake of Recent Events (Cont.)
  - Changing document requests;
  - Contacting Clients:
    - When examiners may contact clients
    - Why client contact may be deemed necessary
    - Ways in which clients may be contacted
    - Avoiding undue client alarm

# *Current Topics*

New and proposed regulations

# *Recent Enforcement Cases*

# Recent Enforcement Cases

- In the Matter of TwinSpan Capital Management, LLC, Barton Asset Management, LLC and Frederick J. Barton (LR – 20609)
- Former registered representative of a national broker-dealer and a formerly registered IA located in Georgia
- Allegations:
  - Barton misappropriated \$970,000 from a single elderly brokerage customer
  - Barton, acting individually or through TwinSpan, engaged in an unrelated \$1.5 million offering fraud
  - Barton misappropriated \$685,000 from an advisory client of TwinSpan
- Status:
  - Received permanent injunctive relief, including disgorgement, prejudgment interest and civil penalties

# Recent Enforcement Cases

- In the Matter of Stephen L. Hochberg (LR – 20619)
- Unregistered IA located in Sudbury, Massachusetts
- Allegations:
  - Obtained at least \$1.5 million from six investors for a purported real estate investment fund that did not exist
  - Obtained a total of \$150,000 from an elderly investor for a purported investment in tax free investment fund
  - To conceal the fraud, used personal funds and funds received from other investors to make sporadic interest payments
- Status:
  - Pled guilty to eight counts of wire fraud and nine counts of fraud in connection with the purchase or sale of a security. Hochberg sentenced to prison.

# Recent Enforcement Cases

- In the matter of WealthWise LLC and Jeffrey A. Forrest (LR – 20737)
- RIA located in San Luis Obispo, California
- Allegations against both respondents:
  - Fraudulently failed to disclose a material conflict of interest when recommending investments
  - Recommended that more than 60 clients and/or \$40 million in assets invest in a hedge fund that made undisclosed subprime and other high-risk investments
- Status:
  - Instituted public administrative and cease-and-desist proceedings

# Recent Enforcement Cases

- In the matter of Robert C. Brown Jr. (LR – 20653)
- RIA located in Hillsborough, California
- Allegations:
  - Misappropriation of more than \$20 million from investors who were falsely promised that their money would be invested in the stock market
  - Employing a Ponzi scheme tactic
- Status:
  - Seeking permanent injunctive relief, including disgorgement, prejudgment interest and civil penalties



# Recent Enforcement Cases

- In the matter of Cornerstone Capital Management, Inc. and Laura Jean Kent (IA – 2778)
- RIA located in Redwood, California
- Allegations against both respondents:
  - Invested clients funds in five investments that bore the hallmarks of classic Ponzi and prime bank schemes
  - Overcharged clients through fees based on inflated value of assets under management
- Status:
  - Instituted administrative cease-and-desist proceedings. This case was subsequently settled.

# Recent Enforcement Cases

- In the matter of LPL Financial Corp., formerly known as Linsco/Private Ledger Corp. (IA-2775)
- Registered BD, IA, and transfer agent located in Boston, Charlotte, and San Diego
- Allegations:
  - Failed to implement adequate controls, including some security measures, which left customer information at the branch offices vulnerable to unauthorized access
  - Computer system security breaches by unauthorized person(s) accessed and traded, or attempted to trade, in customer accounts of several of registered representatives
  - Failures left customer information vulnerable to identity thieves or other unauthorized users at the firm's branch offices
- Status:
  - The Commission accepted a settlement in which the respondent agreed to pay a \$275,000 penalty

# Recent Enforcement Cases

- In the matter of M.A.G. Capital, LLC and David F. Firestone (IA-2849)
- RIA located in Los Angeles, California
- Allegations:
  - M.A.G. took warrants from three hedge funds that it advises (the “Funds”) without compensating the Funds for them
  - M.A.G. did not adequately disclose that the warrants were being paid for by the Funds
  - Firestone aided and abetted the above allegations
- Status:
  - Settled administrative cease-and-desist proceedings

# Recent Enforcement Cases

- In the matter of Westgate Capital Management, LLC and James M. Nicholson (LR – 20911)
- Unregistered investment management firm located in Pearl River, New York
- Allegations against both respondents:
  - Misrepresented the value of the hedge funds to current and prospective investors in 11 hedge funds managed by the adviser
  - Solicited investors with sales materials that claimed nearly impossible record of investment success
- Status:
  - Seeking permanent injunctions, disgorgement, and financial penalties

# Recent Enforcement Cases

- In the matter of Locke Capital Management Inc. and Leila C. Jenkins (LR – 20936)
- RIA with offices in New York and Rhone Island
- Allegations against both respondents:
  - Invented several large advisory client accounts to gain credibility and attract legitimate investors
  - Reported to clients, potential clients, and the SEC, that assets under management were more than \$1 billion, while actual client assets totaled only \$165 million
- Status:
  - Seeking permanent injunctions, disgorgement, and financial penalties

# Recent Enforcement Cases

- In the matter of MedCap Management & Research LLC and Charles Frederick Toney, Jr. (IA – 2802)
- State-registered IA located in San Francisco, California
- Allegations:
  - engaged in “portfolio pumping” – pushing up the price of a thinly-traded holding to boost fund asset values at the end of a reporting period
- Status:
  - Instituted public administrative cease-and-desist proceedings

# Recent Enforcement Cases

- In the matter of WG Trading Investors, L.P., WG Trading Comp., LP, Westridge Capital Mgmt., Inc., Paul Greenwood and Stephen Walsh (LR – 20912 )
- Unregistered investment vehicle in NY, Reg. BD in CT, and RIA in California
- Allegations:
  - Since 1996, the respondents misappropriated as much as \$554M
  - Greenwood and Walsh solicited a number of institutional investors, including educational institutions and public pension and retirement plans, by promising to invest their money in an "enhanced equity index" strategy that involves purchasing and selling equity index futures and engaging in equity index arbitrage trading
- Status:
  - Seeking permanent injunctions, disgorgement, and financial penalties

# *Examination Focus Areas*



# Portfolio Management

# Portfolio Management

- Allocation of investment opportunities among clients
- Consistency of portfolios with clients' investment objectives
- Disclosures to clients
- Consistency of operations with applicable regulatory requirements and the firm's code of ethics

# Portfolio Management

- Potential risk areas:
  - Discretionary authority
  - Differing types of accounts with similar objectives (separate accounts, hedge funds, etc.)
  - Competing investment strategies
  - Differing compensation structures
  - Investing for proprietary accounts
  - Investing in affiliates
  - Voting client proxies

# Portfolio Management

- Common deficient practices:
  - Firm did not-
    - adopt or maintain policies and procedures relating to its investment decision-making
    - maintain required books and records to corroborate investment decisions
    - disclose all conflicts of interest

# Portfolio Management

- Adviser's self assessment of the effectiveness of its compliance program in the area of portfolio management:
  - Questions you can ask
  - Analyses you can perform

# Portfolio Management

- Controls observed:
  - Segregation of duties
  - Forensic testing and documentation
  - Disclosure
  - Client communication
  - Front-end compliance
  - Regulatory awareness

# Use of Service Providers

# Service Providers

- An adviser may choose to engage service providers to perform a number of important services for advisory clients.
- Service providers may include administrator, pricing agent, proxy voting agent, and/or fund accountant.
- Services may include:
  - financial reporting
  - tax and regulatory services
  - create and maintain required fund books and records
  - value portfolio securities and accounts
  - prepare regulatory filings
  - calculate client account expenses
  - vote client proxies
  - monitor arrangements with other service providers.



# Service Providers

- Potential risk areas:
  - Heavy reliance on service providers
  - Frequent change of service providers
  - Use of an affiliated service provider

# Service Providers

- Common deficient practices:
- Firm did not-
  - adopt or maintain policies and procedures relating to its use of service providers
  - adequately oversee the activities of services providers
  - disclose affiliations and conflicts of interest

# Service Providers

- Adviser's self assessment of the effectiveness of its compliance program regarding the use of service providers:
  - Questions you can ask
  - Analyses you can perform

# Service Providers

- Controls observed:
  - Periodic evaluation of services
  - Confidentiality agreements
  - Disclosure
  - Oversight
  - On-site visits

# Safeguarding Client Assets

# Safeguarding Client Assets

- Qualified custodians
- Client reporting
- Preventing unauthorized access
- Determining whether client funds or securities have been lost, misused, or misappropriated
- Asset verification and reconciliation process

# Safeguarding Client Assets

- Potential risk areas:
  - Precarious financial condition of the adviser
  - Use of affiliated custodian
  - Use of a foreign financial institution.
  - Inexperienced auditor
  - Adviser charges performance fees

# Safeguarding Client Assets

- Noted deficient practices:
  - Client funds or securities have been lost, misused, or misappropriated
  - Funds are not maintained with a qualified custodian
  - Inadequate reporting
  - Missing or insufficient audit
  - Inadequate disclosure



# Safeguarding Client Assets

- Adviser's self assessment of the effectiveness of its compliance regarding the safeguarding of client assets:
  - Questions you can ask
  - Analyses you can perform

# Safeguarding Client Assets

- Controls observed:
  - Reconciliation procedures are in place
  - Routine verification of assets and fees assessed
  - Statements sent directly to client
  - Use of experienced auditor
  - Awareness of regulatory changes

# Safeguarding Client Assets

- Custody Verification and Reconciliation Process
  - Obtain custodian statements directly from custodian
  - Compare custodian statements with advisory records
  - Take additional steps to confirm assets when custody is with the adviser or an affiliate
  - Review client account statements

# Performance Claims

# Performance Claims

- Accuracy of performance claims
- Disclosures
- Policies and Procedures
- Forensic metrics
  - Smoothing
  - Outlier Performance
  - Bias Ratio

# Performance Claims

- Potential risk areas:
  - Performance is heavily marketed
  - Overlapping duties
  - Performance-based compensation
  - Completion of RFPs
  - Thinly traded or difficult to value securities used in performance calculations

# Performance Claims

- Common deficient practices:
  - The adviser did not have any compliance policies and procedures governing marketing and performance advertising
  - Advertising did not include all required disclosures
  - Inappropriate inclusion or exclusion of information
  - False information was presented
  - Adequate backup was not maintained

# Performance Claims

- Adviser's self assessment of the effectiveness of its compliance program regarding performance claims:
  - Questions you can ask
  - Analyses you can perform



# Performance Claims

- Controls observed:
  - Detailed performance and marketing policies and procedures
  - Use of exception reporting
  - Performance verification reports from third-party
  - Regular reviews of account inclusion and exclusion criteria
  - Process for ensuring that clear disclosure is provided
  - Regular comparison of performance numbers to appropriate benchmark
  - Review of all marketing materials by compliance staff

# Compliance Resources

# Compliance Resources

- Identification of conflicts relevant to the adviser's business
- Firm-wide risk identification process
- Methods of risk identification:
  - Top-down
  - Layered
  - Bottom-up
  - Dedicated risk staff

# Compliance Resources

- Staffing limitation and segregation of duties and the effect on an effective compliance program
- Appropriate use of compliance staff
- Maintaining adequate administration and oversight
- Testing as a part of routine operations