IA WEEK
A publication of IA Watch

INSIDE...

June 20, 2011

A lesson from CCO enforcement case: Make disclosure 'specific'

Another CCO has settled with the **SEC** over an Advisers Act violation, this time for not disclosing to investors that the RIA pocketed cash from discounted brokerage commission rates rather than passing the money onto clients.

"We thought it was legitimate," says CCO **Douglas Saksa** of the small RIA **Pegasus Investment Management** ($3M in AUM) on Bainbridge Island, Wash. The RIA combined futures trades with another firm. The volume caused the broker to reduce commissions, resulting in a $90,000 windfall for Pegasus.

"The payments stopped once the Commission's Investment Adviser/Investment Company examination staff began asking questions about the payments," states the SEC. It fined Pegasus $95,000, its co-owner **Peter Bortel** $50,000 and Saksa, who is also co-owner, $25,000. Saksa, as CCO, got cited for failure to supervise his partner.

Saksa tells **IA Watch** that the other firm hired Pegasus as a consultant and it interpreted the $90,000 as a payment for services provided. He also says he thought the firm had adequately disclosed that it engages in other business but the SEC said "you have to be specific." The lesson: "You just need to be super scrupulous with regard to disclosure," he says.

Insider trading cases

Other recent enforcement actions include a settlement with **Thomas Hardin**, former managing director at

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Consider these compliance tests to monitor trading at your firm

Have you checked occasionally the e-mail traffic between your traders and your sales team? This could make a good test for best execution, as the e-mails may expose whether your sales staff is directing trades through certain brokers. You could follow up by examining a sales report on which brokers are selling what funds.

Another test – this one targeting potential insider trading – involves three steps: 1. Take your firm's 10 most profitable trades for a period. 2. Look at the purchase and sale dates. 3. Compare the activity against the headlines. Were there big sales of a security just before a significant news story came out about the company?

These are among the compliance tests discussed during **IA Watch**'s June 14 webinar, *An Action-Plan for CCOs to Monitor Trading*. Something as simple as a **Google** search can reveal the big news stories, said **Nicole Vipperman**, VP/compliance officer at **Brookfield Investment Management** ($17B in AUM) in New York

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High court sides with advisory firm in mutual fund disclosure case

One vote can make all the difference, as the U.S. Supreme Court proved last week when, by a 5-4 margin, it ruled for the RIA **Janus Capital Management** ($126B in AUM) in an outcome that will make it more difficult for investors to sue under Exchange Act rule 10b-5 (**IA Watch**, Dec. 13, 2010).

Janus Capital Group v. First Derivative Traders rested on whether an RIA that played a role in assembling a prospectus could be held responsible for misleading statements in the document. The majority opinion written by Justice **Clarence Thomas**, said no, reversing a lower-court case and effectively ending the litigation.

The "maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it," wrote Thomas, who was joined by the conservative flank of the court, plus Justice **Anthony Kennedy**. "One who prepares or publishes a statement on behalf of another

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Tracking Trades (Continued from page 1)

(**IA Watch** 💻, April 4, 2011).

Another tactic she employs is to investigate trades involving securities on the firm's restricted list. Brookfield's system automatically alerts her any time such a trade occurs. She will quiz the PM to make sure no material, non-public information guided the trade. Vipperman also suggests thumbing through your trade blotter for signs of trades involving restricted securities.

Don't limit your scrutiny to the trade blotter. Look through trade confirms, too, suggested **Victoria Hogan** of **NorthPoint Compliance** in Red Bank, N.J., in describing one of her favorite tests when she served as an **SEC** examiner of investment advisers. The confirms may reveal mark-ups and commissions not present in the blotter.

Shifting allocations

Another best practice is to compare initial and final trade allocations. "This is a required books and record" that you must keep, Hogan said. Ideally, you won't spot changes in the allocations but "I actually see that more frequently than I'd like to," she continued. Probe as to the reason for the changes, she recommended.

When it comes to cross and principal trades, you want to make sure the client doesn't get the short end of the stick. Ensure the trader isn't dumping a poor security from one client onto another, urged Hogan. You also should maintain documentation substantiating how the price of the security was determined. You need a client's consent for such trades but this doesn't have to be in writing, although it is a best practice. Vipperman shares her firm's consent form 💻.

She also sends a questionnaire to employees that seeks disclosure about close friends and relatives in the industry. Brookfield scans the results for signs of overfriendly brokers and traders that may influence where to execute trades and damage the effort to seek best execution. Hogan shared a copy of such a conflicts-of-interest questionnaire 💻. Vipperman also has traders report if they've been invited to any prestigious sporting or entertainment event.

Another test Brookfield conducts compares the trading in the personal accounts of traders and portfolio managers against that of the funds they oversee. It looks for signs the employees are depriving clients of opportunities they reserve for themselves or gaming the system by trading just outside blackout periods or selling while buying for the funds.

Red flags you don't want waving on an exam

Don't be surprised if SEC examiners interview your traders, said Hogan. It's a common tactic. She always saw red flags if a firm had too many trading errors or, conversely, none. The latter signals a firm probably doesn't have a system to detect errors.

As an examiner, Hogan felt firms displayed a weakness if trades were communicated verbally because "this could lead to a miscommunication, which could lead to a trade error." Expect a deficiency if you don't keep documentation of trade reconciliations, she added. She also advised CCOs to periodically trace a trade from start to finish to better understand the entire process.

Brookfield invites traders to its trade oversight committee and asks them to reveal trends. Vipperman also advised that firms log any changes to their investment guidelines, including who initiated the amendment and why. This would serve as powerful documentation during an SEC exam, she said.

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Tracking Trades (Continued from page 2)

For clients who choose directed brokerage, be sure they understand this could result in higher commissions and deflect best execution, said **Ben Haskin**, a partner with **Willkie Farr & Gallagher** in Washington. He also noted that "sometimes traders use the term 'soft dollars' differently from how the SEC would use it," e.g., to mean more than research. Educate and train them about soft dollars. The recent update to Form ADV, Part 2 is showing that firms are providing more "robust" disclosure about soft dollars and their potential conflicts, Haskin added.

Editor's Note: Did you miss our webinar? No problem. Order the audio and workbook CD by clicking here. ■

OCIE head lays out guidance for soon-to-be-registered private equity advisers

This week, at a June 22 open meeting, the **SEC** is expected to announce the deadline for registration of larger private equity fund advisers. Those firms would benefit from the words of OCIE Director **Carlo di Florio**, who recently discussed conflicts of interest among PE firms and the role of compliance.

"It begins with a strong compliance program and a knowledgeable, empowered chief compliance officer," di Florio told **PEI**'s Private Fund Compliance conference. "Once the new registration requirements take effect our examiners will be on the lookout for registrants that are not diligent about having effective [compliance] policies and procedures."

He pointed out potential conflicts of interests across the four stages of PE: fund raising, investment, management and the exit stage. For example, an adviser may claim he needs more time to divest a fund but his "ulterior motive" is to continue to receive management fees.

Other conflicts could pop up in everything from the risk of insider trading based on information the adviser has learned to the harm coming to some investors unaware of side letter deals, failure to disclose placement agent fees to misleading marketing pieces. di Florio cited the recent alleged insider trading case in the PE space involving **Matthew Kluger** and alerted advisers to a 2010 report from **IOSCO** that discussed potential conflicts of interests within private equity funds.

"Managing conflicts of interest is part and parcel of good risk management," di Florio said. His examiners would seek to understand "what kind of risk management governance and compliance control frameworks registrants have put in place to mitigate and manage" their risks and whether senior managers "exercise effective oversight of enterprise risk management and embedding risk management in key business processes, including strategic planning, capital allocation, performance management and compensation incentives."

Move slowly on new regs, says commissioner

A speech this month by Commissioner **Troy Paredes** cited an increased "compliance burden on investment advisers" lately due to the pay-to-play rule and revised Form ADV, Part 2 and custody rules. "Assessing the cost-benefit tradeoffs of a particular regulatory course is not just about factoring in compliance costs, however. It is about accounting for a broader range of potential counterproductive effects and unintended outcomes that offset the anticipated benefits of the regulatory change, even if the out-of-pocket compliance costs are low," he said. Paredes advised his fellow commissioners to move slowly in passing Dodd-Frank reforms. "Trying to adopt too many rules and regulations too quickly is fraught with risk," he added.

Editor's Note: Sign up for our next webinar, *Enterprise Risk Management: Real-life Examples to Make the Most of the Nexus with Compliance and Boost Your Program*. It will be held on Tuesday, July 19th at 2 p.m. ET. Register here. ■

SEC's proposed custody rule for broker-dealers touches dually registered firms

When the **SEC** revised its custody rule for advisers, it promised to push a similar rule for broker-dealers. Last week it put out a proposal that actually may save money for dually registered firms that have to pay for an accountant's internal control report under the IA custody rule (**IA Watch**, Sept. 20, 2010).

The new proposal tracks the IA rule in many ways. For example, it would require an accountant to conduct an exam of the broker-dealer – although not a surprise one – and then produce an "Examination Report" that would be shared with the SEC. The good news for dually registered firms, should this proposal be finalized, is that the examination report would replace the need for the IA to undergo the annual internal control report.

The SEC estimates the exam report would cost $150,000 per year per broker-dealer. It places the average cost of the RIA internal control report at $250,000.

Under the proposal, broker-dealers also would have to give the SEC regular reports, including disclosing

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"the number of clients it has as an investment adviser. This would provide the Commission with information about the scale of the broker-dealer's investment adviser activities," the proposal reads. Dually registered firms also would have to report if the custodian "sends account statements directly to the investment adviser clients." ■

FINRA 'encourages' broker-dealers to assist RIAs with pay-to-play compliance

It's been a vexing issue since the **SEC** finalized its revised pay-to-play rule: How can affected advisory firms discover government pension funds buried deep within omnibus accounts? The difficulty has led to reports the SEC may push back the deadline for compliance with this piece of the pay-to-play rule past this September, when it is due to take effect (**IA Watch**, May 9, 2011). Now **FINRA** enters the fray with a suggestion that its members play fair with advisers.

It has put out a notice to its members that "encourages firms to make reasonable efforts to assist investment advisers seeking to comply with" custody rule 206(4)-5. It "may be difficult for an investment adviser to identify government investors when shares in a covered investment company managed by the investment adviser are held through an intermediary," the notice continues (**IA Watch**, Nov. 22, 2010).

FINRA quotes the SEC as saying "it is not uncommon for participant contributions to Sections 403(b) and 457 plans to be commingled into an omnibus position that is forwarded to the fund, making it more challenging for an adviser to distinguish government entity investors from others." It urges cooperation with advisers to "the extent that the information requested is readily available." You could remind brokers who decline to help you of FINRA's notice. ■

High Court Rules (Continued from page 1)

is not its maker," continued Thomas, who created the analogy of a "playwright whose lines are delivered by an actor." In this case, the actor was the **Janus Investment Fund** that hired the RIA.

Justice **Stephen Breyer**'s dissent claims the majority misread court precedent. Breyer jostled with his adversaries over the definition of the word "make." He also believes the prospectus statements could be tied to Janus Capital because of its proximity to the investment fund. "The relationship between Janus Management and the Fund could hardly have been closer. Janus Management's involvement in preparing and writing the relevant statements could hardly have been greater," wrote Breyer.

No effect on the SEC's ability to pursue cases

The decision also rejected the **SEC**'s claim that making a statement is akin to creating it, which it had made in its amicus brief. The agency's only comment, from spokesman **John Nester**, was that the court's decision "makes clear that the SEC has tools to pursue such cases."

But the bar for investors has inched higher thanks to the decision, which follows on another industry victory in last year's *Jones v. Harris* High Court case (**IA Watch**, April 19, 2010).

Janus Capital chose not to comment. Its attorney, **Mark Perry**, a partner with **Gibson Dunn** in Washington, says the decision "builds on Jones versus Harris to clarify who does what and what they can be liable for." An investment adviser's role is defined by its contract with a mutual fund, he adds. The case is "a reminder that the fraud provisions in the securities laws don't apply in every single circumstance," says Perry.

The case is about private securities litigation, says **Barry Barbash**, a partner with **Willkie Farr & Gallagher** in Washington, and the court's decision "continues a trend" from the 1990s in which the justices have trimmed the ability of investors to sue under rule 10b-5 – a rule that forbids the making of false statements about material matters.

"It's good news for all potential defendants because it's broader than investment advisers," Barbash continues.

An attorney for **First Derivative**, **Ira Press**, a partner with **Kirby McInerney** in New York, says the ruling robs cheaters of accountability. "The fear … is that this really might open the door to certain unscrupulous corporate managers to be able to mislead" investors with immunity, he says. Perry mocks this view.

Justice Thomas wrote that "Congress and not the courts" should decide if greater liability should reside within the Exchange Act.

For now, a clear line has been drawn – but one that rests on one justice's vote. Perry notes the High Court has decided two other cases for investors this term by 9-0 votes. The 5-4 vote in Janus, along with recent past split-decisions in similar cases, "clearly exposes something of a philosophical or jurisprudential rift within the court" around Exchange Act liability, Perry adds. ■

This story first appeared as breaking news at www.iawatch.com on June 15. ■

Advisers can exceed ownership limits when investing in foreign funds

The **SEC** has granted an adviser's request to shed the limits on a mutual fund's ownership of another investment company if the acquired entity is a foreign fund, according to a new no-action letter.

Red Rocks Capital ($789M in AUM) in Golden, Colo., sought "greater flexibility" in its "investment objectives" and asked the SEC for permission to blow through the percentage ownership limits within the Investment Company Act. The act includes a 3% ownership limit on outstanding voting stock of the other investment company, a 5% limit on total assets invested in the other investment company and a limit of no more than 10% of its total assets invested in the acquired investment company and all other investment companies.

The SEC agreed it wouldn't recommend enforcement action because "the Commission has no significant regulatory interest in protecting the Subject Foreign Funds." Also, Red Rocks pledged that each fund's board of trustees would oversee the fund's fee structure and would disclose fees and expenses related to the foreign fund in each domestic fund's prospectus fee table.

Deborah Bielicke Eades, an attorney with **Vedder Price** in Chicago, who represents the RIA, says the SEC's interpretation should help advisers seeking to purchase foreign funds on an exchange in the secondary market. Other legal impediments would block this same protection for off-shore hedge funds or other types of open-end funds, she adds.

The SEC's decision makes sense because "it's very difficult to assess and monitor compliance with foreign mutual companies because they're not structured to meet our U.S. laws," says Eades. "They have no reason to comply with our laws." ■

Lawsuit against dually registered firm over 12b-1 fees tossed by federal judge

In what's shaping up as a month full of legal victories for the industry, a federal judge in New York has dismissed a lawsuit against two **Oppenheimer** funds that faced allegations of breach of fiduciary duty for paying non-commission compensation to their broker-dealer.

"Had the decision gone the other way, it would have exacerbated the pressure on registered reps also to register as investment advisers if they were going to receive 12b-1 fees," says **Ned Dodds**, a partner at **Dechert** in New York.

But Judge **Leonard Sand**'s decision found the plaintiff's assertion to be "without merit." "Plaintiff contends that broker-dealer dual registrants who receive any form of compensation other than transactional commissions cannot offer investment advice under the IAA to holders of brokerage accounts," he wrote. "Under this theory of liability, the ultimate fault would lie with the broker-dealers themselves, and Plaintiff may sue them for violating the IAA."

"I don't think a claim against the brokers would be an easy one to bring either," opines Dodds. The plaintiff's attorney declined to comment. Dodds calls their effort an attack on 12b-1 fees. He notes the topic can be heavily influenced, though, by the **SEC**'s proposal to end 12b-1 fees (**IA Watch**, July 26, 2010) and talk of holding broker-dealers to a fiduciary duty on par with investment advisers. ■

SEC opens door for SIPC to cover some claims from alleged Stanford fraud

Hours after Sen. **David Vitter**'s (R.-La.) vow last week to block the nominations of **Daniel Gallagher** and **Luis Aguilar** to be **SE**C commissioners, the agency moved to satisfy the senator's demands. It granted **SIPC** the ability to go to court to liquidate the Stanford broker-dealer, a move that would give investors an opportunity to seek reimbursement for some or all of their losses.

SIPC responded that it will "analyze" the SEC's action, noting this was "the first time" the agency has given it a green light to move on Stanford. The SEC provided an exhaustive analysis to support its decision. It basically concludes that the Stanford CDs were securities and that the investors were "deemed to have deposited their cash with" Stanford, the two conditions needed to justify SIPC coverage.

The SEC also stated that it wouldn't take no for an answer should SIPC balk. "The Commission has authorized its staff to file an action in federal district court under [the Securities Investor Protection Act] to compel SIPC to initiate a liquidation proceeding in the event SIPC does not do so."

A Vitter spokesman called the development good news for harmed investors and stated that the senator is awaiting more details from the SEC but that he's likely to lift his block. Vitter, who says he represents many of Stanford's victims, has questioned the SEC's actions for some time (**IA Watch**, Aug. 24, 2009).

The president had nominated the two commissioners last month – Gallagher to replace Commissioner **Kathleen Casey** and current Commissioner Aguilar to a

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full five-year term (**IA Watch**, May 23, 2011). They appeared before the Senate this week, which must approve the president's nominees. The Senate's rules can allow one senator to hold up nominations.

An SEC spokesman had no comment.

Stanford is undergoing an evaluation to see if he's mentally capable of standing trial (**IA Watch**, Feb. 18, 2011). He has maintained his innocence. ■

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the New York hedge fund **Lanexa Management**, on insider trading charges. He will have to pay $40,000 but more gravely faces jail time for a related criminal conviction.

Alexei Koval has already been sentenced for a conviction on insider trading charges. He is to serve 26 months in prison and has been ordered to pay a $1.4 million fine. Authorities describe him as a financial adviser who had worked at **Western Asset Management Company**. A spokeswoman at the RIA says the conviction wasn't related to his job at the firm or his trading while there and that it is cooperating fully with authorities. The firm declined to describe to **IA Watch** what it does to prevent insider trading.

And another Madoff soldier has fallen. **Eric Lipkin** pleaded guilty to six counts of fraud, including falsifying books and records of an investment adviser. He faces up to 70 years in prison. With the criminal case closed, the SEC charged Lipkin with fraud this month, noting the employee "received annual bonuses from the firm, including for his work to mislead auditors and examiners, and he received $720,000 from [Bernard] Madoff to purchase a house, an amount he never paid back." ■

Rep. Frank urges SEC not to impose adviser fiduciary duty standard on B-Ds

In a May 31 letter sent to **SEC** Chairman **Mary Schapiro**, Rep. **Barney Frank** (D-Mass.) uses the law that shares his name to sway the Commission away from adopting for broker-dealers a fiduciary duty standard that matches that of investment advisers.

The Dodd-Frank law "was not intended to encourage the SEC to impose the Investment Advisers Act … standard on broker-dealers, but to ensure that the new standard would not be a 'watered down' version of the investment advisors' fiduciary standard," Frank writes. The SEC had no comment on the letter.

The Dodd-Frank "language adopted recognizes some of the differences between broker-dealers and investment advisors, particularly with respect to the receipt of commission income and the fact that many broker-dealers do not continually provide advice to their customers," the letter continues. Frank then bluntly writes that if Congress intended the same standard for both "it would have simply repealed the broker-dealer exception," which lawmakers rejected.

He tacitly pushes the Commission toward a standard that recognizes the differences in models. ■

This story first appeared as breaking news at www.iawatch.com on June 3. Read more from this story at www.iawatch.com. ■

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