

**MEMO# 22739**

July 28, 2008

## **SEC Publishes Its Second Compliance Alert Summarizing Recent OCIE Exam Findings**

[22739]

July 28, 2008

TO: EQUITY MARKETS ADVISORY COMMITTEE No. 33-08  
FIXED-INCOME ADVISORY COMMITTEE No. 20-08  
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 28-08    RE: SEC PUBLISHES ITS  
SECOND COMPLIANCE ALERT SUMMARIZING RECENT OCIE EXAM FINDINGS

The SEC staff has published another Compliance Alert summarizing areas recently reviewed by SEC examiners during inspections and describing issues they found that may have resulted in the registrant receiving a comment from the examiners. [\[1\]](#) In addition, unlike the SEC's previous Compliance Alert, [\[2\]](#) this one identifies some of the practices examiners identified that may be effective in preventing violations of the federal securities laws. This year's Alert is divided into three areas: Investment Advisers/Mutual Funds, Broker-Dealers, and Transfer Agents [\[3\]](#). The discussion in the Alert relating to Investment Advisers/Mutual Funds focused on four areas: Personal Trading by Advisory Staff, Proxy Voting and Funds' Use of Proxy Voting Services, Valuation and Liquidity Issues in High Yield Municipal Bond Funds, and Soft Dollar Practices of Investment Advisers, each of which is briefly summarized below.

### **Personal Trading by Advisory Staff**

The Alert's discussion of this issue identifies the following as "deficiencies frequently identified" by the SEC's examiners:

- An incomplete code of ethics (e.g., failure to require access persons to obtain pre-

approval before investing in certain limited investment opportunities);

- Permitting employees to engage in practices that deviate from the adviser's code of ethics (e.g., incomplete clearance forms; failure of the adviser to receive duplicate confirmations);
- Failure of access persons to follow reporting requirements and failure of the adviser to monitor compliance; and
- Inaccurate disclosure in the adviser's brochures of its controls over personal trading.

Practices identified by the examiners as appearing "to be effective in preventing violation of the Advisers Act" included:

- Internal Compliance Controls – such as: written policies and procedures designed to address conflicts of interest; accurate and current restricted/watch lists; use of time-stamped order tickets; centralized monitoring of all trading and personal securities transactions; executing customers' trades prior to personal/proprietary trades; strict enforcement of "black-out" periods; prohibitions on short-term trading; effective oversight and documentation of exceptions from the adviser's policies; and ensuring that the adviser receives copies of access persons' trade confirmations and monthly brokerage statements.
- Compliance Review and Reporting – such as: timely and well-documented trade allocations; timely and well-documented pre-approval of personal securities transactions and after-the-fact reconciliations; effective information barriers between customers' trades and trades for the adviser's proprietary account or employees' accounts; comparing performance of customers' accounts to proprietary/employee accounts; price adjustments being made as necessary; trades made by the reviewer of personal securities transactions being reviewed by another officer or control person of the adviser; persons who violate the adviser's policies being reprimanded; and appropriate reporting of code of ethics violations to the funds' board of directors.

The Alert additionally notes that, "at many of the advisory firms that appeared to have effective compliance programs in this area, compliance personnel were actively involved in implementing those programs."

## **Proxy Voting and Funds' Use of Proxy Voting Services**

According to the Alert, SEC examiners reviewed practices "with respect to the use of third-party proxy voting services, including the oversight and operational aspects of mutual funds' proxy voting, and how advisers managed conflicts of interest in proxy voting." Deficiencies noted by the staff in this area include the following:

- Proxy voting policies and procedures that contained inaccurate information or that were not followed;
- "Weak" board oversight of proxy services providers (e.g., failure to have controls

confirming that the service providers' recommendations were consistent with the funds' policies and procedures);

- The adviser's failure to document its assessment of the proxy service as necessary to determine whether the adviser had established and implemented measures reasonably designed to identify and address the proxy firm's conflicts of interest;
- Funds voting inconsistently with their proxy voting policies;
- Funds failing to file Form N-PX or filing an incomplete form;
- Funds failing to include disclosure in their SAs regarding the availability of the proxy voting policies and procedures as required by Form N-1A; and
- "Improper fees charged." According to the Alert, "an adviser allocated proxy service fees to funds, purportedly for services rendered, which did not hold voting securities that would require such services." Also, "another adviser" apparently failed to adequately disclose that it used soft dollars to pay for proxy voting services unrelated to issuer research.

According to the Alert, effective processes for identifying potential conflicts of interest with respect to proxy voting include relying on the fund's chief compliance officer (CCO), the adviser's proxy coordinator, or other advisory employees to identify such conflicts. It further notes that, "[t]he proxy coordinator was often a senior employee knowledgeable about potential conflicts of interest that may exist between the adviser and its clients."

## **Valuation and Liquidity Issues in High Yield Municipal Bond Funds**

The Alert notes that the staff conducted "targeted" examinations of high yield bond funds, which focused on portfolio composition, valuation, and transaction activities. Rather than identifying deficiencies identified during these examinations, the Alert include lists issues the examiners "noted." [\[4\]](#) These issues are:

- Portfolio composition – in particular, the examiners noted that "[h]igh yield funds with higher average credit qualities, fewer unrated securities, and few distressed and defaulted securities were generally less likely to have issues regarding valuation and liquidity raised by examiners."
- Disclosure – examiners noted that high yield funds "often" did not disclose or adequately disclose their increased risk with respect to liquidity and valuation – particularly when there was "a dramatic increase" in the percentage of the fund invested in illiquid securities.
- Third-party pricing services – the examiners noted three issues in this area. First, funds representing that they utilized "independent" pricing services when, in fact, pricing services relied on the funds to provide information needed to value securities held by high-yield funds. Second, pricing services relying on fund management to provide information may have resulted in stale review periods and stale valuations for exempt securities. Third, funds sometimes were unable to sell securities at approximately the evaluated prices provided by a price service. According to the Alert, examiners "may comment if the board does not consider this information when subsequently evaluating the accuracy of the evaluated prices provided by the pricing service."
- Cross Trades – The Alert notes that the "few funds examined" that crossed trades

between clients in securities for which there was no secondary market information were unable to document that the prices of such securities “sufficiently represented market values.”

- Board Oversight – Notwithstanding this heading in the Alert, this discussion did not mention fund boards. Instead, it noted that “some funds did not adequately assess the accuracy of prices provided by pricing services.”
- Records Retention – The Alert notes that, “while not required,” funds that use electronic records for their compliance reviews “allow for more efficient analysis and review of fund records for valuation anomalies and patterns requiring further research.”

## **Soft Dollar Practices of Investment Advisers**

This portion of the Alert discusses common industry practices examiners observed in examinations that were undertaken to gain a better understanding of soft dollar arrangements and practices, including the policies and procedures advisers use to obtain best execution. According to the Alert, examiners observed the following:

- Products and Services – The advisers examined generally received both proprietary and third-party products and services through their soft dollar arrangements with broker-dealers. Research and trade execution assistance products and services were the most common. “A few” advisers received products and services outside the Section 28(e) safe harbor.
- Total Commissions Directed – “All the advisers examined who had soft dollar arrangements told examiners they had informal commission ‘targets’ with the broker-dealers who provide them with third-party or proprietary research services.” Such targets were intended as guides and not obligations. While anywhere from 3 to 100% of these advisers’ total client commissions were directed to broker-dealers through which the advisers earned soft dollar credits, they averaged 20%. Commissions on transactions that earned soft dollar credits ranged from \$0.01 to \$0.08 per share, with an unweighted average commission rate on soft dollar trades of \$0.05 per share.
- Best execution analyses – Most advisers documented their efforts to seek best execution and they typically conducted period execution quality reviews on an annual, semi-annual, or quarterly basis. In conducting their best execution analysis, some advisers compared the amount they might have been “paying up” against the actual value of the research. Where advisers have not evaluated the value of the research received through soft dollar credits, and the commissions are higher than examiners would expect, “examiners may question whether the advisers have overpaid for such research.” Examiners may also raise questions when advisers accumulate large soft dollar credit balances at broker-dealers. In such instances, examiners are interested in determining if the commissions paid have been reasonable, particularly if the commissions are high and the broker was not receiving products or research.
- Disclosures – Most of the advisers appeared to be in compliance with the disclosure requirements relating to the use of soft dollars, including requirements to disclose the existence of conflicts of interests related to soft dollar use. Examiners would comment when an adviser did not disclose its conflicts of interest or when it did not disclose the receipt of products and services outside the Section 28(e) safe harbor.

Compliance Policies, Procedures, and Controls – Most advisers had policies, procedures, and controls relating to soft dollars, though they varied among firms. “[E]ffective practices required the adviser to maintain reports of soft dollar arrangements and transactions, reconcile commissions on a periodic basis, review mixed-use product allocation, and ensure that its CCO or a committee approve, in advance, specific products and services acquired with soft dollars.”

Tamara K. Salmon  
Senior Associate Counsel

#### **endnotes**

[1] See ComplianceAlert (July 2008), which is available at:  
<http://www.sec.gov/about/offices/ocie/complialert0708.htm>.

[2] See ComplianceAlert (June 2007), which is available at:  
<http://www.sec.gov/about/offices/ocie/complialert.htm>.

[3] The portions of the Alert relating to transfer agent activities were sent to the Institute’s Transfer Agent Advisory Committee via separate memo and are not included in this memo. The few observations in the Alert concerning transfer agents related to practices with respect to lost security holders.

[4] Related to the issue of valuation is the section in the Alert relating to broker-dealers. It discusses findings from examinations of “select large broker-dealer firms,” which were conducted to assess their valuation and collateral management practices relating to subprime mortgage-related products. In addition to noting that “examiners observed increased difficulty for firms in independently verifying their inventory valuations due to a lack of market liquidity” and firms becoming “more reliant on modeled prices,” the Alert cites several deficiencies uncovered during these examinations.