

MEMO# 11866

May 9, 2000

SEC LETTER SUMMARIZING TYPES OF VIOLATIONS FOUND DURING INSPECTIONS OF INVESTMENT ADVISERS

[11866] May 9, 2000 TO: COMPLIANCE ADVISORY COMMITTEE No. 18-00 INVESTMENT ADVISER ASSOCIATE MEMBERS No. 13-00 INVESTMENT ADVISER MEMBERS No. 14-00 RE: SEC LETTER SUMMARIZING TYPES OF VIOLATIONS FOUND DURING INSPECTIONS OF INVESTMENT ADVISERS

The SEC's Office of Compliance Inspections and Examinations ("OCIE") recently sent the attached letter to federally registered investment advisers to inform them of the types of violations of the Investment Advisers Act of 1940 found during compliance examinations and to assist them in fostering compliance with the Act. The nature and examples of violations discussed in the letter are described below.

- ! Duty to Disclose -- examples of violations of an adviser's duty to disclose material information include failing to disclose: all fees that a client would pay in connection with the advisory contract; how fees are charged; whether fees are negotiable; and the adviser's affiliation with other securities professionals such as broker-dealers or issuers.
- ! Trade Allocation -- according to the letter, an adviser can defraud its clients by allocating trades inequitably among clients by, for example: disproportionately allocating hot IPOs to favored accounts without disclosing this practice to clients; waiting to decide how to allocate based on subsequent market movements; and failing to use the average price paid when allocating and failing to disclose this practice to clients.
- ! Advertising Representations to Clients -- violations of the Advisers Act prohibitions against making misleading statements or omitting material facts include: the use of testimonials; the use of the initials "R.I.A." on printed material (because this suggests a level of professional competence, education or other special training); and a reference to past specific recommendations made by the adviser without complying with the conditions of Rule 206(4)-1 under the Act.
- ! Performance Claims -- examples of performance claims that may be fraudulent include: an inaccurate claim of AIMR compliance; creating distorted performance results; comparing the adviser's performance to inappropriate indices; representing that model or backtested performance is actual performance; failing to deduct the adviser's fees from performance calculations without disclosure; and representing falsely the adviser's total assets under management, credentials, or length of time in business.
- ! Personal Trading -- examples of abusive personal trading activities include front-running and directing clients to trade in securities in which the adviser has an undisclosed interest.
- ! Advisory Agreement Violations -- an adviser may be cited for failure to fulfill a contractual obligation if it: calculates fees differently from the methodology agreed to in the contract; fails to comply with a client's wishes concerning directed brokerage; or causes clients to invest in securities that are inconsistent with the level of risk that clients have

agreed to assume. ! Books and Records -- an adviser's books and records may be found deficient if it fails to make or preserve the records required by Rule 204-2 under the Advisers Act. ! Referral Arrangements -- A referral arrangement violation occurs when an adviser fails to comply with the requirements of the cash solicitation rule (Rule 206(4)-3) under the Act and the corresponding recordkeeping requirements of Rule 204-2(a)(10) and (15). ! Use of Brokerage -- examples of violations in this category include: allocating brokerage to a broker in exchange for client referrals without full disclosure of the practice, or the fact that clients pay higher brokerage commissions and do not obtain best price and execution; and allocating brokerage in exchange for soft dollars without disclosure. ! Custody or Possession of Client Assets -- the letter provides examples of arrangements constituting custody, which would necessitate compliance with the custody rule (Rule 206(4)-2) under the Act. These include: having a general power of attorney over a client account; having signatory power over a client's checking account; maintaining an omnibus-type account in the adviser's own name at a broker or bank in which client securities are maintained after a trade settles; obtaining advisory fees by directly billing client custodians without effective oversight by the client or an independent party; serving as a trustee of client trusts; or acting as the general partner of a limited partnership client. ! Inadequate Internal Control and Supervisory Procedures -- examples of internal weakness found by OCIE include: operating procedures that allow a portfolio manager to value securities recommended, or override values provided by a custodian, for purposes of reporting to clients and calculating advisory fees without any independent review; establishing comprehensive written control procedures but not properly monitoring its business for compliance with such procedures; and not having an oversight process. Tamara K. Reed Associate Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment referred to in this Memo, please call the ICI Library at (202) 326-8304, and ask for attachment number 11866. ICI Members may retrieve this Memo and its attachment from ICINet (<http://members.ici.org>).